

Reforming the Indirect Tax Landscape: An Empirical Study on the Impact of Goods and Services Tax on Micro, Small and Medium Enterprises in India

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Abstract

The introduction of the Goods and Services Tax (GST) in India on 1 July 2017 represents the most significant overhaul of indirect taxation since independence, replacing a fragmented system of central and state levies with a unified, technology-driven regime built on the principle of "one nation, one tax." Micro, Small and Medium Enterprises (MSMEs), which contribute nearly 30 percent of GDP, 45 percent of manufacturing output, and 40 percent of total exports while employing over 110 million people, sit at the centre of this transformation. This paper examines how GST has reshaped the operating environment for MSMEs by drawing on secondary sources from the Ministry of MSME, the GST Council, CBIC, and RBI, and by triangulating these with primary field responses collected from ten MSME units in Gangtok, East Sikkim. The findings indicate that GST has simplified registration and return filing, eliminated the cascading effect of multiple indirect taxes, lowered effective tax rates for several categories of goods, and enabled seamless interstate trade through the e-way bill and input tax credit mechanisms. At the same time, the study documents a set of persistent frictions, including higher compliance costs in the early transition period, working capital pressure arising from delayed refunds, digital-literacy gaps in smaller units, and ambiguity in classification across GST slabs. The paper argues that while GST has delivered meaningful gains for a majority of MSMEs, the next phase of reform must focus on procedural simplification, faster refunds, expanded Composition Scheme coverage, and targeted capacity building so that the benefits of formalisation reach the smallest enterprises.

Keywords: Goods and Services Tax, MSMEs, Indirect Taxation, Input Tax Credit, Tax Compliance, Formalisation

1. Introduction

Taxation is the fiscal backbone of any modern state, and the structure of a country's indirect tax system exerts a direct influence on the cost of doing business, the pace of formalisation, and the competitiveness of its small enterprises. For most of India's post-independence history, indirect taxation was a patchwork of central levies such as excise duty, service tax, central sales tax, and countervailing duty, combined with state levies such as value added tax, entry tax, octroi, luxury tax, and entertainment tax. The effective tax

incidence on a single product routinely crossed thirty percent and in some categories approached fifty percent because of the cascading effect, where tax was levied on top of tax at every stage of the supply chain. Compliance was equally fragmented, with different returns, thresholds, and dates applicable to each levy, and interstate movement of goods was obstructed by check-posts that added time and cost to every shipment.

The Goods and Services Tax, introduced on 1 July 2017 through the One Hundred and First Amendment of the Constitution, was designed to resolve these structural inefficiencies. By subsuming seventeen central and state taxes into a single destination-based consumption tax with four principal slabs, GST aimed to create a unified national market, eliminate the cascading effect through a seamless input tax credit mechanism, widen the formal tax base, and reduce the logistical and administrative friction that small businesses had long absorbed. The reform also introduced an almost fully digital compliance architecture, with online registration, return filing, invoice matching, and the e-way bill system for goods in transit.

For MSMEs, which are defined under the MSMED Act, 2006 and were reclassified in 2020 on the basis of investment and annual turnover, the implications of this shift are particularly consequential. The sector accounts for nearly thirty percent of national GDP, forty-five percent of manufacturing output, forty percent of merchandise exports, and more than 110 million jobs, with a strong presence in rural and semi-urban regions. Yet MSMEs also operate with thin margins, limited working capital, and modest digital capability, which means that even well-intentioned reforms can impose a transition cost that is disproportionate to their size. This study examines how GST has shaped the operating environment of MSMEs in India, focusing on whether the promised benefits of lower tax incidence, simpler compliance, and wider market access have materialised in practice for small enterprises, and where the reform still falls short. A field component based in Gangtok, East Sikkim, is used to contextualise the national picture with perspectives from small retailers and service providers in a northeastern state whose MSME base is dominated by tourism, handicrafts, and small-scale manufacturing.

2.1 Literature Review

The scholarly literature on value-added taxation and its distributional consequences for small enterprises provides the conceptual foundation for this study. Ebrill, Keen, Bodin, and Summers (2001), in their foundational IMF monograph on the modern VAT, established that small businesses bear disproportionate compliance costs relative to large enterprises under any VAT regime, and argued for simplified turnover-based schemes to counterbalance this regressivity. Cnossen (2003), in his cross-country assessment of OECD VAT systems, emphasised that threshold-based exemptions are essential to shield micro and small firms from prohibitive compliance costs, and recommended periodic inflation-linked revisions of those thresholds, a recommendation that has since been reflected in India's evolving GST threshold policy. Slemrod and Venkatesh (2002) quantified the regressivity of compliance costs in the United States and found that they fall more heavily on small firms as a share of tax paid, a finding that resonates strongly with the Indian MSME experience. Djankov, Ganser, McLiesh, Ramalho, and Shleifer (2010), in a cross-country study of 85 jurisdictions, documented a positive relationship between simplified business taxation and the formalisation of small enterprises.

A second strand of literature examines GST specifically in the Indian context. Sharma (2017), in an early assessment of the GST rollout, concluded that the replacement of multiple indirect taxes with a single tax would, in the long run, benefit both MSMEs and consumers by raising manufacturing output, supporting employment, and strengthening formalisation. Franco and Chellammal (2018) identified both positive and negative impacts on small-scale industries, highlighting in particular that GST has the potential to reduce the borrowing costs of MSMEs by bringing them into the formal credit-appraisal framework of banks and NBFCs. Jayalakshmi and Venkateswarlu (2018) acknowledged transitional difficulties during the first year of implementation but argued that GST would, over time, improve the competitiveness of Indian MSMEs relative to both domestic large firms and foreign competitors operating from lower-cost jurisdictions. Agarwal, Sekhani, and Mohan (2018), in field studies conducted in Rudrapur and Malappuram, found that the one-time transition cost borne by MSMEs was significantly lower than the cumulative cost of obtaining VAT and service tax registrations under the earlier regime, but also documented an increase in ongoing compliance costs driven by higher fees charged by tax professionals.

More recent empirical work has refined this picture. Kumar (2018), surveying 250 MSMEs in Rajasthan, reported that 68 percent of respondents experienced increased compliance costs in the first year of GST, while 54 percent found it difficult to adapt to the digital filing system. Patel and Patel (2019), in a comparative analysis of pre- and post-GST tax burdens for textile MSMEs in Surat, documented a net reduction in effective tax incidence for exporters as a result of seamless input tax credit, but noted that domestic-facing units faced working capital pressure from delayed refunds. Singh (2020), using SIDBI credit portfolio data, found that GST-registered MSMEs demonstrated measurably better creditworthiness and access to formal credit than their unregistered peers, suggesting that GST-driven formalisation carries a significant indirect financial dividend. Sharma and Gupta (2021) evaluated the Composition Scheme and concluded that while it meaningfully reduced the compliance burden for eligible micro enterprises, its uptake was constrained by limited awareness, the inability to issue tax invoices, and its non-availability for interstate suppliers. Nair and Karthikeyan (2022) examined food-processing MSMEs in Kerala and Tamil Nadu, documenting clear gains from the removal of multiple cesses and entry taxes, but also drawing attention to classification confusion across GST slabs for processed and unprocessed foods. Mishra and Das (2023), in a multi-state study covering 500 MSME respondents, found that the post-GST period was associated with stronger interstate trade activity, better invoice management, and deeper integration of MSMEs into the supply chains of larger firms.

Taken together, this literature establishes that GST has produced real structural gains for India's MSMEs, but that these gains are unevenly distributed across sectors, regions, and firm sizes. What remains under-researched is the longitudinal and multi-sector impact of the reform, particularly after the 2020 revision of MSME classification and the steady refinement of compliance rules over subsequent GST Council meetings. The present study seeks to contribute to that gap by combining a synthesis of this literature with primary field responses drawn from MSMEs in a northeastern state that has received limited attention in the existing research.

2.2 Research Gap

Although the body of work on GST and MSMEs has grown significantly since 2017, three gaps remain. First, the majority of empirical studies are either sector-specific, such as textiles or food processing, or confined to a single industrial state, which limits their generalisability to a diverse national MSME base. Second, the cumulative and longer-term impact of GST on MSME profitability, working capital, and growth, beyond the initial two to three transition years, has not been systematically examined. Third, very few studies incorporate field perspectives from northeastern states, where MSMEs operate under distinctive geographic and logistical conditions and where lower threshold limits historically applied. This study addresses these gaps by drawing together the national policy picture with primary responses from Gangtok, East Sikkim.

3.1 Research Questions

1. How has the implementation of GST affected the ease of starting and running MSMEs, particularly in terms of registration, compliance, and interstate trade?
2. To what extent has GST delivered on its promises of lower tax incidence, a unified national market, and reduced cascading effects for MSMEs?
3. What structural and procedural challenges continue to constrain MSMEs under the GST regime, and what policy measures are most likely to resolve them?

3.2 Research Objectives

1. To examine the loopholes and inefficiencies of the pre-GST indirect tax system and assess how the GST framework has addressed them for the MSME sector.
2. To evaluate the impact of GST on key operational dimensions of MSMEs, including tax compliance, cost structure, customer base, and competitiveness, with field evidence from Gangtok, East Sikkim.
3. To offer evidence-based policy recommendations aimed at strengthening the MSME sector's participation in the formal tax system.

3.1 Research Design

This study follows a descriptive and analytical research design with a mixed qualitative and quantitative orientation. The descriptive component accurately portrays the structure of the pre-GST indirect tax system, the architecture of the current GST regime, and the operating conditions of MSMEs in India. The analytical component examines the causal linkages between GST provisions and MSME outcomes, with particular attention to compliance cost, tax incidence, market access, and formalisation. The study does not rely on statistical hypothesis testing but takes an interpretive approach, combining secondary evidence with a small primary survey to build a coherent, evidence-based argument about the reform's impact.

3.2 Data Collection

The study draws on both secondary and primary data. Secondary data was collected from five categories of sources, namely official government and regulatory publications from the Ministry of MSME, the GST Council, the Central Board of Indirect Taxes and Customs, and the Reserve Bank of India; domestic academic literature on GST and MSMEs published in peer-reviewed journals and edited volumes between 2017 and 2023; international institutional literature on value-added taxation, particularly from the IMF and the OECD; industry and market research from SIDBI, FICCI, and CII; and credible financial journalism for recent developments that have not yet entered the academic literature. Primary data was collected through a structured questionnaire circulated to ten MSME units in Gangtok, East Sikkim. The questionnaire contained ten closed-ended items framed on a five-point Likert scale, and covered ease of doing business, tax compliance, tax burden, customer base, market unification, competitiveness, and growth.

3.3 Mode of Collection

Given the constraints of the COVID-19 pandemic during the field phase, the questionnaire was administered digitally through email, WhatsApp, and Facebook Messenger, and supplemented where possible by short telephonic conversations to clarify responses. The literature search followed a keyword-driven approach using terms such as "GST impact MSME," "GST compliance cost small business," "Composition Scheme India," and "input tax credit MSME," with a preference for publications from 2017 onward. Each source was evaluated against four criteria, namely credibility, relevance, recency, and internal consistency across cross-referenced sources.

3.4 Analytical Approach

The analysis combines thematic synthesis of the secondary literature with descriptive statistical analysis of the primary responses. Thematic analysis was used to identify recurring patterns in the literature, including compliance cost, cascading effect, formalisation, working capital, and Composition Scheme uptake. The primary data was tabulated, converted to percentages, and represented graphically through pie charts and bar charts. Because the primary sample is small and regionally concentrated, the quantitative findings are interpreted as indicative rather than statistically generalisable, and are read in conjunction with the wider secondary evidence.

3.5 Limitations

The study has three main limitations. First, the primary sample is limited to ten MSMEs in a single city, which restricts statistical generalisation to the wider Indian MSME base. Second, the field phase coincided with the COVID-19 pandemic, which constrained both access to respondents and the range of MSME categories that could be reached. Third, the study relies on self-reported perceptions of GST's impact rather than audited financial data, which means the findings reflect how MSME owners experience the reform rather than a precise measurement of tax-induced changes in profitability.

4.1 Analytical Technique

The analysis proceeds in two layers. The first layer synthesises the secondary evidence on GST's structural impact on MSMEs across compliance, taxation, market access, and formalisation. The second layer presents descriptive findings from the ten-respondent primary survey conducted in Gangtok, East Sikkim, and interprets them against the broader national picture. A purely quantitative approach would have been inappropriate for this subject, because the material under study spans policy documents, industry reports, academic studies, and field responses, and what is needed is an interpretive framework that can draw meaning from sources that differ in format and purpose.

4.2 Structural Impact of GST on MSMEs

At the structural level, GST has delivered four clearly documented gains for MSMEs. The subsuming of seventeen central and state indirect taxes into a single levy has eliminated the multiplicity of compliance touchpoints that MSMEs previously had to navigate, and has reduced the effective tax rate on a significant number of goods from a pre-GST range of roughly thirty to thirty-five percent to a post-GST range of eighteen to twenty-two percent in most categories. The seamless input tax credit mechanism has removed the cascading effect of tax on tax, which had earlier inflated final prices and compressed MSME margins. The abolition of interstate check-posts, combined with the nationwide e-way bill system, has cut transit times for goods moving across state borders and expanded the addressable market for MSMEs that previously operated only within their home state. Finally, GST registration has become a de facto signal of formality that MSMEs use to access bank credit, supply to larger enterprises, and participate in public procurement, which in turn has deepened their integration into the formal economy.

4.3 Compliance and Cost Impact

The compliance picture is more mixed. The GST Network platform has digitised registration, return filing, refund claims, and invoice matching, which has meaningfully reduced the transactional cost of tax administration for MSMEs that have adapted to the digital environment. However, the shift to mandatory digital compliance has also generated costs that are unevenly distributed across the MSME base. Smaller units with limited digital infrastructure have had to invest in GST-compliant accounting software, train or hire staff to manage monthly returns, and engage tax professionals whose fees have risen in line with the complexity of filings. Working capital pressure arising from delayed input tax credit refunds, particularly for exporters and domestic suppliers with long receivable cycles, has been flagged in multiple sector-specific studies and remains a live issue. The Composition Scheme has helped mitigate the compliance burden for the smallest eligible enterprises, but its uptake has been constrained by its inability to accommodate interstate supplies and by restrictions on passing on input tax credit to buyers.

4.4 Primary Survey Findings

The primary survey conducted in Gangtok, East Sikkim, broadly aligns with the structural and compliance picture that emerges from the secondary literature, while adding a regionally specific perspective. On the question of whether the implementation of GST has made it easier to start and run an MSME compared

to the previous tax system, eighty percent of respondents either strongly agreed or agreed, ten percent were neutral, and ten percent disagreed. On whether GST has simplified tax compliance, ninety percent of respondents either strongly agreed or agreed, and none disagreed, indicating strong endorsement of the digital compliance architecture despite the transitional challenges associated with it.

Responses on tax burden were more ambiguous. Seventy percent of respondents felt that GST continued to be a burden on both customers and MSMEs, although a similar proportion, seventy percent in aggregate, also agreed that GST has lowered effective tax rates and provided meaningful relief on several categories of goods. This apparent contradiction reflects a pattern visible in the wider literature as well, where MSMEs recognise the reduction in headline tax rates but continue to experience working capital strain from compliance-linked cash flow timing. On the question of whether GST has enabled MSMEs to extend their customer base across state borders, fifty percent of respondents agreed or strongly agreed, reflecting the expanded market access made possible by the abolition of interstate barriers, while thirty percent were uncertain and twenty percent disagreed, a pattern likely linked to the logistical constraints of operating from a northeastern state.

On the question of market unification, fifty percent of respondents agreed that GST has moved India closer to a single national market, while forty percent disagreed, most likely because products such as petroleum and alcohol remain outside the GST regime, preserving some of the pre-reform fragmentation. Responses on whether GST has led to the growth of MSMEs were cautiously positive, with sixty percent agreeing or strongly agreeing, ten percent neutral, and thirty percent disagreeing. Taken together, the primary responses suggest that the MSMEs surveyed have experienced genuine structural gains from GST alongside real but solvable frictions, and that the overall balance of opinion leans toward the reform having been net positive for their businesses.

4.5 Challenges

Five challenges emerge consistently across the secondary literature and the primary responses. First, the digital compliance environment imposes a real cost on micro enterprises with limited technological capacity, and the support infrastructure at GST Seva Kendras needs to be deepened in smaller cities and rural areas. Second, working capital pressure arising from delayed input tax credit refunds continues to affect exporters and domestic suppliers with long receivable cycles. Third, the exclusion of petroleum, alcohol, and certain electricity-related levies from GST preserves residual cascading and undermines the goal of a fully unified tax base. Fourth, classification ambiguity across GST slabs, particularly in food processing, handicrafts, and mixed-service categories, continues to generate compliance risk and occasional over-taxation. Fifth, the Composition Scheme, while valuable for the smallest units, remains constrained in its coverage and requires expansion to deliver its full potential.

4.6 Opportunities

Four opportunity areas emerge from the analysis. First, continued procedural simplification of return formats, refund processing, and invoice matching would materially reduce the compliance cost that MSMEs still bear. Second, expanding the Composition Scheme to cover a wider slice of the micro

enterprise base, including selected interstate supplies, would accelerate formalisation at the bottom of the MSME pyramid. Third, the integration of GST data with MSME credit-scoring models, which is already underway at institutions such as SIDBI, can use GST-generated transaction records to unlock formal credit for enterprises that previously operated outside the formal financial system. Fourth, targeted digital-literacy and tax-literacy programmes delivered in regional languages, particularly in tier-2 and tier-3 cities and in northeastern states, would ensure that the benefits of GST formalisation reach enterprises that currently experience the reform primarily as a compliance burden.

5.1 Findings

The study yields five principal findings. First, GST has meaningfully simplified the indirect tax landscape for MSMEs by subsuming seventeen central and state levies into a single tax and by eliminating the cascading effect, with a majority of surveyed respondents agreeing that the reform has made it easier to start and run a business. Second, effective tax rates on many categories of goods have moved from a pre-GST range of thirty to thirty-five percent to a post-GST range of eighteen to twenty-two percent, which has translated into real relief for MSMEs, even as a parallel perception of compliance-linked burden persists. Third, the digital compliance architecture has simplified return filing and refund claims for adequately equipped MSMEs, but has also generated a transition cost that falls disproportionately on the smallest units with limited digital capacity. Fourth, the abolition of interstate barriers has expanded the addressable market for MSMEs and strengthened their integration into the supply chains of larger firms, with fifty percent of surveyed respondents reporting an expansion in their customer base. Fifth, structural frictions remain, including the exclusion of key commodities from GST, classification ambiguity across slabs, and constrained uptake of the Composition Scheme, and these represent the principal agenda for the next phase of reform.

5.2 Conclusion

GST is the most consequential indirect tax reform India has implemented since independence, and its impact on the MSME sector is best understood as a structural gain accompanied by a set of transitional and procedural frictions. The reform has delivered on its principal design objectives by unifying the national market, eliminating the cascading effect, reducing effective tax incidence on a broad range of goods, and creating a digital compliance architecture that has pulled a significant share of the informal economy into the formal tax base. At the same time, the reform has imposed a compliance cost that is unevenly distributed across the MSME base, has generated working capital pressure for a subset of firms, and has not fully eliminated the fragmentation that persists because of the exclusion of certain commodities and the limitations of the Composition Scheme. The evidence from both the secondary literature and the primary survey indicates that a majority of MSMEs have experienced GST as a net positive, but that the distributional challenges of the reform are real and require active policy attention. The next phase of the GST story will be shaped less by the architecture of the tax itself and more by the quality of its implementation, the speed of procedural simplification, and the reach of the support infrastructure that accompanies it.

6.1 Recommendations

The government should continue to simplify GST return formats and refund processing, with particular attention to faster input tax credit disbursement for exporters and domestic suppliers whose receivable cycles strain their working capital. The Composition Scheme should be expanded in both its turnover threshold and its product coverage, and exit procedures should be simplified so that growing micro enterprises can transition smoothly to the standard regime. The GST Council should examine the phased inclusion of petroleum and alcohol within the GST framework to complete the unification of the national market and eliminate the residual cascading that currently applies to these products. The CBIC and state tax departments should deepen the network of GST Seva Kendras in tier-2 and tier-3 cities and in northeastern states, with a particular focus on regional-language tax-literacy programmes for micro enterprises. Financial institutions should continue to integrate GST transaction data into their MSME credit appraisal models, since the formalisation dividend of GST is most powerfully realised through improved access to bank credit. Individual MSME owners should invest early in GST-compliant accounting software, maintain clean invoice and reconciliation practices, and use the Composition Scheme where eligible to minimise the compliance burden during their growth phase.

6.2 Limitations of the Study

This study has three principal limitations. First, the primary sample is limited to ten MSMEs in Gangtok, East Sikkim, which restricts the statistical generalisability of the field findings to the wider national MSME base, although the secondary evidence is used to provide a broader context. Second, the field phase coincided with the COVID-19 pandemic, which constrained both the diversity of respondents and the depth of in-person engagement. Third, the study relies on self-reported perceptions of GST's impact rather than audited financial data, which means the findings reflect how MSME owners experience the reform rather than a precise financial measurement of its effects on their profit and cash flow.

6.3 Scope of the Study

The study focuses on the Indian MSME sector and covers developments from the rollout of GST on 1 July 2017 through to 2024. The primary field component is based in Gangtok, East Sikkim, and is complemented by a synthesis of the national-level secondary literature. Future research should extend the field component to a larger and more geographically diverse MSME sample, should incorporate audited financial data to quantify the reform's impact on profitability and working capital, and should undertake longitudinal analysis of Composition Scheme uptake and the formalisation dividend across multiple phases of GST Council rate rationalisation.

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