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GST and the Unorganized Sector: An Empirical Analysis of the Effects of India's Goods and Services Tax on Small and Medium-sized Enterprises (SMEs)

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Abstract

The introduction of Goods and Services Tax (GST) in India on 1 July 2017 was a very big change in our tax system, as we all know. This study tries to look at how GST has affected small and medium businesses, especially those working in the unorganized sector, which is commonly seen in Indian people doing business. By using information from government reports, research papers, and some industry surveys, this paper explains both the good and bad sides of GST. On one side, GST helped in bringing one market system, better transport movement, and more clarity in tax payment. But on the other side, many small businesses faced problems. They had to deal with heavy paperwork, delay in getting input tax credit refunds, and shortage of working money. Supply chains which were running for years also got disturbed. This study shows that moving from unorganized to organized system is not easy or direct. Many small firms are adjusting slowly and carefully, which can be called limited or bounded formalization. In the end, the paper suggests that the GST system should be made more supportive so that small businesses can grow smoothly and survive better in the formal economy of our country.

Keywords; *Goods and Services Tax (GST), Small and Medium-sized Enterprises (SMEs), Unorganized Sector, India, Tax Compliance, Formalization, Input Tax Credit (ITC), Working Capital, Economic Impact.*

Introduction

Small and medium businesses, along with the unorganized sector, are the real base of the Indian economy, as we all know. In our country, after agriculture, these businesses give jobs to the highest number of people. Before GST came, many reports showed that SMEs were giving more than 30 percent to India's GDP and nearly half of our exports also came from them. Around 11 crore people were getting work from this sector, which is very big. Most of these businesses come under the unorganized sector, which is commonly seen in Indian people doing small trade or local work. These are usually run by individuals or families, with less than ten workers, and are easy to start. They depend more on labour and local demand. Government data also shows that this sector alone was creating more than half of the country's income and giving work to almost the full workforce in some estimates. Recent survey data says that more than 7 crore such units are working now, giving jobs to over 12 crore people. Because of this large role, any major change like GST clearly affects jobs, income, and overall growth in our country. Before 2017, India's indirect tax system was very confusing and heavy, especially for small businesses. There were many types of taxes like excise duty, service tax, VAT, CST, octroi, and different state taxes. This created lot of trouble. One big problem was tax on tax, where businesses had to pay tax again on already taxed value. Input tax credit was not properly adjusted, mainly in inter-state trade. Because of this, costs were high and movement of goods was slow. Small firms suffered more, as they did not have systems or experts to manage this. So when GST was introduced, it was not just a tax change, but a full system change, and it naturally had deep impact on SMEs and the unorganized sector. This broken tax system did not only increase paperwork, but it also divided the Indian market in many ways. Because of CST on inter-state sales and entry taxes at state borders, moving goods from one state to another was costly and slow. Many times, it was easier to sell inside the same state than outside. So businesses preferred local buying and selling, which is commonly seen in Indian people running small firms. Due to this, big supply chains at national level could not grow properly. The problem was not just about procedure. It was a deep issue that stopped India from becoming one connected market. The idea of one GST for the whole country was first discussed in the year 2000, as we all know, but it took many years to come into action. After long discussions between centre and states, GST was finally started on 1 July 2017. It came through a change in the Constitution and was said to be the biggest tax reform after independence. The main aim was simple. One nation, one tax. Many central and state taxes were removed and merged into one system. GST was brought to remove tax on tax, connect the national market, and make the system more clear and honest. India followed a dual GST model. This means both centre and states collect tax. For sales within a state, CGST and SGST are charged. For inter-state trade, IGST is applied by the central government. This helps in smooth flow of tax credit between states. Different tax rates were fixed, like 0, 5, 12, 18, and 28 percent. Daily use items were kept at lower rates, while luxury goods were taxed more. Overall, this new system was planned to replace the old confusing taxes with a cleaner and more transparent method for our country.

Literature Review

Academic writings on GST usually show two different views, as we all know. One side talks about the good results like better system and higher efficiency. The other side focuses on the problems and disturbances it created. In the beginning, government reports and policy notes said that GST will increase tax collection, reduce leakage, and bring more people into the tax system. It was believed that a simple tax structure will help businesses follow rules easily and move towards formal system in our country. Many studies have also talked about the positive changes expected from GST. Some researchers said that GST can remove old tax problems and create a fair tax structure. They felt that business growth will improve and trade between states will become smoother. The idea of one national market and more transparency was appreciated by many writers. For small and medium businesses, GST was expected to stop tax on tax through input tax credit, reduce confusion, and help them reach bigger markets. But at the same time, many independent studies showed a different reality, especially for small and informal businesses. These studies pointed out that the burden of following GST rules is heavier on small firms. Micro businesses spend more of their income on compliance than big companies. They have to pay for accounting software, tax experts, and also give time for online filing. For many SMEs, this became a big challenge, as digital knowledge and money resources are limited, which is commonly seen in Indian people running small businesses. Another big problem discussed in many studies is the pressure on working capital, as we all know cash flow is very important for small businesses. Some researchers have clearly said that delay in getting input tax credit refunds created serious trouble for MSMEs. Many companies faced long waiting time for refunds. Because of this, money got stuck and daily business operations were affected. Around two third of firms reported refund delays, and more than half said their cash cycle became weak, especially in manufacturing and export businesses. This problem became worse in sectors where tax on inputs was higher than tax on output, which is commonly seen in Indian industries. Studies also show mixed results on business performance after GST. Some research found that GST helped few firms by improving efficiency and profit in the long run. But many other studies reported that most SMEs saw a fall in sales and profit in the early period after GST. Because of this, researchers agree on one thing. GST has future benefits, but the short-term problems were heavy for small firms. So, the literature clearly suggests that government should improve the system. Simpler returns and faster refunds are needed so that all small businesses in our country can get equal benefit from GST.

Methodology

This study follows a simple descriptive and analytical research method. It uses both number based data and written information taken from secondary sources, as we all know collecting primary data is not always easy. The study mainly depends on government reports, research papers, and published surveys. The aim is to understand the impact of GST on small businesses and the unorganized sector in our country, without doing field surveys. In the analysis part, data from before GST and after GST is compared to see the changes. Important areas like business turnover, profit level, compliance cost, and working capital position are observed. Common problems and benefits mentioned in different studies are grouped together using a theme-based approach. By using information from many reliable sources, this study tries to give a clear and balanced view of how GST has affected SMEs. This method helps in understanding the overall policy impact across sectors and regions, which is commonly seen in Indian economic studies.

The Dual Realities of GST for SMEs

One clear benefit of GST for small businesses was the removal of trade barriers inside the country, as we all know. Earlier, there were many taxes like CST and also check-posts at state borders. Trucks used to wait for hours, sometimes whole day, just for tax checking. This caused delay, more fuel cost, and extra labour cost. After GST, these check-posts were removed and one national market was created. The e-Way Bill system also helped in smooth movement of goods. Because of this, many SMEs were able to send their products to other states easily. They could reach new markets and manage their supply chains better, which is commonly seen in Indian people doing business across states. Another important part of GST is the input tax credit system. This system allows businesses to get credit for the tax they already paid on raw materials or services. Then they can adjust it with the tax they collect on final sales. So tax is charged only on the value added, not again and again. For small businesses, this is a big advantage in theory. It helps in reducing overall tax burden and lowers the cost of goods. Because of this, SMEs can offer better prices and compete more strongly in local as well as export markets in our country. GST system is fully based on digital process, as we all know. Registration, return filing, and tax payment are done online through the GST portal. Because of this, every transaction gets recorded properly. This brings more transparency in business activity. Banks and financial institutions can check these records and understand the business better. So for small businesses, getting loans and working capital becomes easier. RBI also mentioned that this digital system can help MSMEs by making procedures simple and improving their financial visibility in our country. GST also tries to create equal competition in the market. Before GST, many unorganized businesses were outside tax system and sold goods at lower prices by avoiding tax. This was unfair for honest SMEs. With GST registration and proper invoices, more businesses are coming into the formal system. This helps competition based on quality and efficiency, which is commonly seen in Indian markets. At the same time, government understood that very small businesses need support. So the registration limit was increased. Many micro units with low turnover were kept outside compulsory GST. For small firms above this limit, the composition scheme was introduced.

An Empirical Assessment of GST's Challenges for the Unorganized Sector

Even though GST has many benefits on paper, real studies show that small businesses faced many serious problems in the starting period. The move to an online and rule heavy system was not easy for SMEs and the unorganized sector. As we all know, small firms have less staff and less money. Research shows that the smallest businesses spend more time on GST work like filing returns and matching bills. Micro firms spend many hours every month only on GST work, while bigger firms spend less time. Even though large companies pay higher fees, small firms lose more money compared to their total income. Many micro businesses spend a fixed amount every month just to stay compliant, which hurts them more. This problem becomes bigger because businesses have to buy accounting software and depend on tax consultants. For many unorganized businesses, digital knowledge is low, which is commonly seen in Indian people doing small trade. So instead of simplification, GST created a new monthly cost. Small firms now depend on private service providers to manage GST work. The burden did not go away. It just shifted. Another very serious issue is working capital problem. Delay in getting input tax credit refunds has blocked money for many SMEs. Small firms had to wait many days to get their refund. This affected their ability to pay suppliers, salaries, and other daily costs. The situation is worse in industries where tax on raw material is higher than tax on final product. Sectors like textiles, footwear, and printing face this issue a lot. For example, printers pay high tax on paper but low tax on finished boxes. This gap creates constant cash shortage. Many small businesses work on very small profit margins. Because of this blockage, some firms are forced to take loans from informal sources at high interest, which further reduces their income.

GST also changed how supply chains work. To claim tax credit, a business must buy only from registered suppliers who file returns properly. Because of this, big companies prefer to deal only with registered firms. Earlier, they used to buy from small unorganized suppliers also. Now this relationship is breaking. This puts pressure on unorganized businesses to register under GST, even if they are not required by law. Many small firms registered only because their customers demanded GST invoices. So GST registration became compulsory in practice, not by rule. All these problems together affected business performance. Many studies showed that after GST, a large number of SMEs saw a fall in sales. More than half reported a drop in monthly turnover. The impact was strongest on micro enterprises. Almost all very small firms reported loss in turnover. This clearly shows that while GST may help in the long run, the short-term impact was heavy on small businesses in our country. Another study also supports this pattern, as we all know the impact of GST was not same for all businesses. Bigger SMEs were able to increase their turnover after GST. Their growth was around 6 to 9 percent. But very small firms did not see much improvement. Micro businesses showed only around 4 percent growth. This clearly shows the difference. Large firms were more ready for digital systems and new rules. Small firms, on the other hand, struggled with cost and process, which is commonly seen in Indian people running tiny businesses. Other research also says that many small firms faced higher expenses and lower profit in the first few years after GST. So the benefit was uneven, and the burden was heavier on the smallest businesses in our country.

Sector-Specific Analysis

The effect of GST was not same for all sectors, as we all know. Different types of businesses felt it in different ways. Small firms in manufacturing, services, and trade all work differently. But GST rules were applied in one common way. Because of this, some sectors faced special problems. This clearly shows that one single tax system may not suit everyone in the same manner. For manufacturing SMEs, GST brought both good and bad results. On the positive side, they could now claim input tax credit on machines and other capital items. Earlier this was not allowed fully. Transport and movement of goods also became easier, which reduced cost. Many manufacturers improved their efficiency because of this. But at the same time, manufacturing firms suffered most from working capital issues. Delay in refunds and higher tax on raw materials created serious cash problems. The textile sector is a good example. In the beginning, many textile units faced trouble due to higher tax on synthetic materials and complex GST rules. Turnover dropped for many medium size firms. Slowly, some changes were made. Export goods were kept tax free and duty structure was adjusted. This helped exports and encouraged businesses to move into organized system. The problem was not inefficiency of firms. It was more about mismatch between GST design and how the textile industry works in our country. Service sector businesses faced a different situation. After GST, many service providers had to register for the first time. The GST rate for services was fixed at 18 percent, which was higher than earlier tax. Because of this, either service prices increased or profits went down. This pressure was strongly felt by small service providers, which is commonly seen in Indian people working in local service activities.

Service sector small businesses also faced many problems after GST, as we all know. One big issue was service classification. They had to use HSN codes, which were mainly made for goods, not services. Because of this, many service providers got confused. Wrong classification sometimes led to wrong tax payment and fear of notices from tax office. Another big burden came for those working in more than one state. Earlier, one central registration was enough. But under GST, they need separate registration for each state. This increased paperwork and cost, which is commonly seen in Indian people running small service firms. For traders and retailers, GST changed the way they buy goods and earn profit. To get input tax credit, many traders stopped buying from unorganized suppliers and moved to registered sellers. Old business relationships were broken. Even though this helped formal system, it also disturbed supply chains that were working well and at low cost. The composition scheme became popular among small traders because it is simple. But it has some serious limits. Traders cannot claim input tax credit and also cannot charge GST from customers. So the tax paid becomes their own cost. For businesses working on small margins, even one percent tax on full turnover makes a big difference. This creates a tough choice. Either choose easy compliance and lose profit, or go for normal GST and handle heavy rules to stay competitive in our country.

Conclusion

The evidence from many studies clearly shows two sides of GST impact on small businesses in India. On one side, GST has helped in long term changes. It created one national market, reduced transport problems, and pushed businesses towards formal system. This also helped in getting bank loans and made business dealings more transparent, as we all know. But at the same time, GST created serious short term problems, especially for very small firms. Compliance work increased, working capital got stuck, and supply chains were disturbed. The pain was not equal for all. Micro enterprises suffered the most. Big firms adjusted faster, but small ones struggled to survive in the early period. Because of this pressure, the unorganized sector did not fully move into formal system. Instead, a middle path was seen, which is commonly seen in Indian people doing small business. Many firms registered under GST only because they had to. For example, they took registration to keep their big customers, but continued some parts of business in informal way to reduce cost. This shows that formalization is not a simple yes or no process. It is more of a slow and careful adjustment. This also shows the gap between policy planning and real life situation of small businesses in our country.

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