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GOODS AND SERVICES TAX (GST) AND ITS EFFECT ON SMALL AND MEDIUM ENTERPRISES (SMEs) IN INDIA

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ABSTRACT

The GST, implemented in India in 2017, marked a transformative overhaul of the indirect tax system with significant implications for SMEs. This paper examines GST's impact on Indian SMEs through a structured analysis of its outcomes, challenges, and the road ahead. The study is based on recent data and authoritative sources up to 2025. Key findings indicate that GST has broadened the tax base and formalized a large segment of SMEs, facilitating increased MSME registrations and improved access to credit. It has unified the national market by replacing multiple taxes with "one nation, one tax," leading to efficiency gains such as reduced logistics costs and a more transparent business environment. However, the transition has also imposed compliance and operational challenges on SMEs. Many small businesses face higher compliance costs, working capital constraints, and adaptation difficulties under GST's digital and procedural requirements. The paper identifies these challenges in detail and proposes strategic recommendations to enhance GST compliance and promote SME growth. Recommendations include simplifying GST procedures (e.g. easing input credit rules and return filings for small taxpayers), strengthening support systems and training for SME compliance, refining the composition scheme, and addressing structural issues like inverted duty structures. The conclusion emphasizes that while GST has been beneficial in formalizing and integrating SMEs into the economy, continued reforms and supportive measures are crucial to ensure that India's SME sector not only complies with GST but also thrives in the post-GST era.

Keywords: *GST, Indirect Tax, SMEs, Post-GST Era, VAT.*

Introduction

SMEs form the backbone of the Indian economy, contributing roughly 30% of India's GDP and about 45% of the country's exports. The SME sector also provides employment to approximately 110 million people as of 2022-23, making it the second-largest source of jobs after agriculture. Given this vital role, any major economic reform in India – especially in taxation – has significant ramifications for SMEs. In this context, the introduction of the GST on July 1, 2017 was a watershed moment. GST unified the nation's indirect tax system by subsuming numerous central and state taxes (like excise duty, service tax, VAT, etc.) into a single tax framework, with the aim of simplifying compliance and creating a common market across India. For SMEs, who previously had to navigate a complex web of taxes and jurisdictional differences, GST promised a more streamlined taxation regime and easier inter-state trade.

In the nearly eight years since its implementation, GST's effect on SMEs has been profound. On one hand, GST has accelerated the formalization of businesses. The number of registered GST taxpayers nationwide roughly doubled from about 6.7 million in mid-2017 to 14 million by 2023. This expansion in the tax base is largely attributable to SMEs entering the GST system. Many smaller enterprises that were previously operating informally or below the tax threshold have opted into GST to access broader markets and supply chains. Notably, even some firms with turnover below the exemption limit chose to register for GST due to business compulsions – a field survey by a government think tank

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(NIPFP) found that over 90% of surveyed micro and small enterprises obtained GST registration regardless of turnover, often because B2B clients demanded dealing only with GST-compliant vendors. This indicates a sweeping change in the business environment where GST registration has become de facto necessary for competitiveness.

At the same time, the transition to GST has not been without difficulties for SMEs. The initial phase of GST saw SMEs struggling with new compliance requirements, technological systems, and cash-flow adjustments. Many SMEs experienced disruptions in their operations and had to invest time and resources to understand the new tax regime. The government has iteratively responded to these concerns – for instance, by increasing the GST registration threshold for businesses dealing in goods from ₹20 lakhs to ₹40 lakhs in 2019, and by raising the turnover limit for the SME-oriented Composition Scheme from ₹1 crore to ₹1.5 crores. Such measures were aimed at easing the burden on the smallest businesses. Still, the net impact of GST on SMEs encompasses both positive outcomes (like greater market integration and input tax credit benefits) and ongoing challenges (like compliance burden and working capital issues).

This research paper provides a comprehensive analysis of GST and its effect on SMEs in India. It begins by outlining the objectives and methodology of the study. It then discusses the impact of GST on SMEs – highlighting formalization, compliance trends, and economic effects – followed by an examination of the challenges SMEs face under the GST regime. Finally, the paper offers strategic recommendations to improve GST compliance and promote the growth of SMEs, before concluding with overall observations. By focusing on authoritative Indian sources including government data and expert surveys, this study aims to present an up-to-date and nuanced understanding of how GST has reshaped the SME landscape in India.

Objectives

- To assess the impact of GST on Indian SMEs, including both positive outcomes (formalization, ease of doing business, market access) and negative effects on operations and finances.
- To identify the key challenges faced by Indian SMEs under GST, such as compliance issues, financial strains, and sector-specific difficulties.
- To provide the strategic recommendations for improving GST compliance and supporting SME growth, focusing on simplifying compliance, reducing burdens, and creating a supportive environment.

Methodology

This study uses a qualitative methodology, analysing secondary data from authoritative sources like the GST Network (GSTN), CBIC, Ministry of Finance, Ministry of MSME, and the GST Council. It also includes insights from reports by organizations such as NIPFP and consulting firms like Deloitte. The research covers the period from GST's implementation in mid-2017 to 2025, examining both quantitative data (e.g., registered taxpayers, MSME registrations) and qualitative insights (e.g., policy documents, SME case studies). No primary survey was conducted; existing survey data were used to understand SME experiences under GST within the Indian context.

Impact of GST on SMEs

GST has had a profound impact on India's SMEs, leading to improvements in tax compliance, business formalization, and operational efficiency while integrating them into the broader economy. Key areas of impact include:

- **Formalization and Expansion of the Tax Base**: GST has formalized many businesses, especially SMEs, into the tax system. The number of GST taxpayers grew from 6.7 million in 2017 to 14 million in 2023, with many small businesses now voluntarily registering due to the benefits of business credibility and supply chain integration. MSME registrations also surged, from 0.5 million in FY2017–18 to 15 million in FY2023–24, driven by GST's transparent registration system.
- **Improved Tax Compliance and Filing Trends**: GST has fostered improved tax compliance among SMEs, with 90% of eligible taxpayers filing their returns on time in 2023–24, up from 68% in 2017–18. The introduction of the Quarterly Return Filing and Monthly Payment (QRMP) scheme has eased compliance for small taxpayers, with around 70% of MSMEs finding it beneficial. The increase in timely filing rates reflects a stronger compliance culture.

- **Access to Input Tax Credit and Reduction of Cascading Taxes**: GST's Input Tax Credit (ITC) mechanism has eliminated the cascading tax effect, benefiting SMEs by lowering their effective tax burden. Essential goods produced by small manufacturers are placed in lower tax slabs or exempted, reducing their tax liabilities. The Composition Scheme for businesses with turnover up to ₹1.5 crore has simplified compliance for micro and small businesses, though its uptake remains modest.
- **One Nation, One Market – Logistics and Supply Chain Efficiency**: GST has improved logistics efficiency by eliminating state-level trade barriers. Trucks now travel 30% more distance per day, reducing transit times and costs. This has particularly benefited SMEs, which operate on thin margins. The removal of interstate checkpoints and reduced logistics costs have made SMEs more competitive in both domestic and global markets.
- **Transparency, Digitization, and Credit Access**: GST's digitization has increased transparency in tax filings, providing SMEs with verifiable financial records. This has facilitated access to formal credit, with bank credit to the MSME sector growing by 20% year-on-year as of 2024. The government has introduced initiatives like the "GST Sahay" platform to help MSMEs access loans against GST invoices, enhancing their financial capabilities.
- **Macroeconomic and Competitive Impact**: GST has levelled the playing field for SMEs by allowing both small businesses and large corporations to claim input tax credits. This has encouraged larger companies to engage with GST-registered SMEs, expanding market opportunities for compliant businesses. GST's standardization has also reduced tax arbitrage, making business location decisions more focused on genuine business needs than tax avoidance.

Table 1: GST's Impact on Formalization and Compliance for SMEs

Indicator	2017–2018	2023–2024
Registered indirect taxpayers	6.7 million	14.0 million
New MSME registrations (annual)	0.5 million	15.0 million
Monthly GST return filers (GSTR-3B)	72.5 lakh (Apr 2018)	113 lakh (Apr 2023)
On-time return filing rate	68% (2017–18)	90% (2023–24)
Average daily truck distance	225 km (pre-GST)	300–325 km (post-GST)

Source: Model All India GST Audit Manual 2023

This table shows the significant improvements in formalization, compliance, and logistics efficiency that SMEs have experienced since the implementation of GST, highlighting a positive trend in tax registration, filing compliance, and operational productivity. These changes reflect the broader impact of GST on SMEs, contributing to a more integrated, transparent, and competitive business environment.

Challenges Faced by SMEs under GST

While the GST system has brought notable benefits for Indian SMEs, the transition and compliance process has been fraught with challenges. SMEs have faced significant difficulties in adjusting to the new tax framework, with some features of the GST regime inadvertently placing pressure on small businesses. The key challenges faced by Indian SMEs under GST include:

- **Compliance Burden and Complexity**: One of the most significant challenges for SMEs is the increased compliance burden. GST requires the filing of multiple returns (such as GSTR-1, GSTR-3B, and annual returns), maintaining digital records, and adhering to frequent deadlines. Many small businesses were unaccustomed to formal bookkeeping and online procedures. A survey revealed that 82% of MSMEs found compliance under GST to be complex and costly. To manage this, SMEs had to hire accountants, purchase accounting software, and invest in computer systems. Additionally, the frequent changes in GST rules added to the confusion. While schemes like the Composition Scheme and QRMP eased some burdens, they still required timely tax payments and filings, which many micro enterprises found challenging.
- **Technological and Infrastructure Barriers**: The digital nature of GST compliance has posed a challenge for SMEs, particularly in rural and semi-urban areas where internet access and digital literacy are limited. In the initial months, the GST portal experienced technical glitches, leading to delays and frustration, especially as filing deadlines approached. SMEs also struggled with the requirement to match purchase invoices with suppliers' uploaded invoices to claim input tax credit (ITC). Any delays or mistakes by counterparties could freeze an SME's ability to claim

credits, penalizing them unfairly. A recent survey indicated that 88% of MSMEs want the government to relax the strict invoice-matching requirement for claiming credits.

- **Working Capital and Cash Flow Strains**: GST has put a strain on SMEs' working capital. Under GST, businesses must pay tax on sales even if payment from the buyer has not been received. This means SMEs often need to remit GST out-of-pocket while awaiting payment, which can stretch to 60-90 days in extended supply chains. A survey found that 59% of SMEs reported blocked working capital as a major issue. Export-oriented SMEs have also faced cash flow issues due to delays in GST refunds, particularly for zero-rated exports. Additionally, the reverse charge mechanism, which requires buyers to pay tax on behalf of unregistered sellers, discouraged SMEs from dealing with smaller vendors, adding to their immediate tax outflows and further squeezing liquidity.
- **Impact on Turnover and Demand**: GST introduced short-term disruptions for many SMEs, leading to a loss of turnover. Reasons for this included confusion over pricing, older stock becoming less competitive due to buyers not being able to claim input credit on pre-GST stock, and a general economic slowdown. A survey showed that 89% of MSMEs reported a decline in sales post-GST, with 53% experiencing a 10–30% drop in revenue, and 36% seeing a decrease of more than 30%. Smaller enterprises were hit hardest, losing business because clients refused to deal with non-GST-registered entities. This forced many SMEs to register, but not before losing some sales. Larger firms were able to streamline compliance and pass on input tax credits, making them more competitive.
- **Sector-Specific Issues and Inverted Duty Structures**: GST's standardized rate structure created challenges for certain sectors, especially SMEs. An inverted duty structure, where the tax rate on inputs is higher than the tax rate on outputs, led to cash flow issues for sectors like textiles and footwear. For example, raw materials like synthetic yarns were taxed at higher rates than finished products, causing credits to accumulate and requiring time-consuming refunds. Though the GST Council has since adjusted rates to correct such anomalies, the initial impact was significant for SMEs in affected sectors. Additionally, the 18% GST on services increased costs for some service providers, dampening demand. The introduction of the Composition Scheme for services in 2019 aimed to ease this, but uptake has been limited.
- **Frequent Changes and Uncertainty in Early Phase**: Frequent policy changes in the early years of GST created uncertainty for SMEs, which lacked dedicated tax teams to keep up with the changes. From rate alterations to the introduction of e-way bills and changes in GST forms, the environment felt unstable. Many SMEs struggled to adapt to the evolving system, and the need to constantly adjust systems or product prices created frustration. Although the regime has stabilized since 2019, the early phase left some SMEs with negative perceptions, with 22% of MSMEs still citing compliance burden as a challenge in 2023.
- **Compliance Enforcement and Penalties**: GST introduced stricter compliance enforcement through mechanisms like e-way bills, e-invoicing, and automated mismatched-return notices. This has increased scrutiny on SMEs, many of which have faced penalties for minor clerical errors or mismatched declarations. While these measures aim to protect revenue, they add psychological pressure on small businesses. Moreover, fraud cases involving fake invoicing led to verification drives that occasionally caught legitimate businesses in red tape. These measures, though necessary to curb evasion, have added to the compliance burden for SMEs.

While GST has helped formalize many SMEs and improved compliance, it has also imposed substantial challenges. From the complexity of compliance and digital infrastructure barriers to working capital strains and sector-specific issues, SMEs have had to adapt to a new tax regime. Recognizing these challenges is essential for policymakers to guide reforms that ensure SMEs can fully benefit from the GST framework in the long term.

Strategic Recommendations for Compliance and Growth

The implementation of GST has provided a foundation for a more integrated business environment, but there is still room to refine the system for better accommodation of SMEs. The following strategic recommendations aim to address the challenges faced by SMEs under the GST regime and promote their compliance and growth:

- **Simplify and Liberalize the Input Tax Credit Process**: A primary concern for SMEs is the complexity of claiming input tax credits (ITC). To address this, the government should consider relaxing the invoice-matching requirement for small businesses. This could involve allowing SMEs to provisionally claim ITC based on their purchase invoices without strict reliance on suppliers' GSTR-1/GSTR-2B data, at least for businesses under a certain turnover limit or within a reasonable discrepancy range. By easing this process, the government can reduce instances where credits are blocked due to seller delays or errors. Additionally, expediting the clearance of refund claims related to excess credits and inverted duty structures would ensure small businesses' cash flow is not unnecessarily tied up.
- **Enhance MSME-Friendly GST Schemes**: The government should strengthen SME-focused provisions like the Composition Scheme to increase adoption. Relaxing restrictions such as the ban on interstate sales for composition dealers could benefit small businesses that engage in occasional out-of-state orders. Raising the turnover threshold for the Composition Scheme (currently ₹1.5 crore) would ensure growing SMEs aren't prematurely pushed into the full GST system. Similarly, the 6% composition scheme for services should have its threshold increased, considering inflation in the service sector. Introducing a cash accounting scheme for very small businesses would further ease cash-flow issues, enabling them to pay GST when they receive payments rather than when the sale occurs.
- **Improve GSTN System and Provide Technical Support**: Continued investment in GSTN's infrastructure is essential to handle high return filing volumes without glitches. Simplifying the user interface for small taxpayers, perhaps through a "GST Lite" mobile app, would help SMEs comply more easily. Expanding the network of GST Suvidha Kendras in small towns would provide much-needed assisted compliance services. Regular training workshops and webinars through industry associations and the Ministry of MSME should be conducted to reduce unintentional non-compliance. Additionally, implementing a graded penalty system or "safe harbor" rules for small businesses could offer reduced penalties for minor errors, making the enforcement process less punitive.
- **Streamline Audits and Enforcement with an SME Focus**: The current audit and enforcement approach can be intimidating for SMEs. The government should formulate SME-friendly audit guidelines, such as setting materiality thresholds below which discrepancies can be settled without heavy fines. Reducing duplicate audits by central and state tax authorities and standardizing documentation requirements would simplify the audit process for small businesses. Data analytics could be leveraged to make compliance easier, such as providing SMEs with pre-filled return data and notifications about anomalies, allowing them to rectify issues proactively.
- **Address Sectoral Issues and Rationalize GST Structure**: The government should continue addressing inverted duty structures and irrational rates that affect SMEs. For instance, where inputs for SME-heavy sectors are taxed higher than outputs, either rate adjustments or prompt refund mechanisms should be put in place. Additionally, the government should ensure any changes to GST law or rules are made with adequate notice and consultation, allowing SMEs time to prepare. Transition plans should be clear to avoid disruptions caused by abrupt changes.
- **Financial Support and Incentives for Compliance**: Compliance is costly for SMEs, and the government should consider offsetting some of these costs. One option is to offer tax credits or deductions for GST compliance expenses such as software, accounting services, or audit fees. Expanding incentive schemes, like the 2% interest subvention for MSME loans, would encourage more informal businesses to formalize. Furthermore, facilitating easier access to working capital based on GST returns would provide SMEs with direct financial benefits from being tax-compliant.
- **Strengthen Communication and Feedback Mechanisms**: Ongoing communication between the government and SME stakeholders is crucial for refining GST. A dedicated sub-committee on SME GST issues could interact with small business associations, providing a platform to flag region-specific or sector-specific challenges. Simplifying GST notifications and offering guides in regional languages would make compliance easier for SMEs across India. Additionally, highlighting success stories of GST-compliant SMEs could build confidence in the system.

Conclusion

The implementation of GST in India has significantly advanced the formalization of the SME sector, bringing millions of small businesses into the tax net and fostering a culture of compliance. By replacing multiple taxes with a unified system, GST has reduced inter-state barriers and created a national market for SMEs. Benefits like input tax credits, improved logistics, and enhanced transparency have boosted competitiveness and integration into national and global value chains. However, the initial GST design-imposed strains on smaller businesses, with high compliance costs, cash-flow pressures, and system complexities disproportionately affecting them. Despite government relief efforts, such as raising thresholds and simplifying returns, challenges persist. Strategic recommendations, including simplifying input credit processes, refining the composition scheme, and providing incentives, aim to better support SMEs. The ongoing discourse on "GST 2.0" indicates that incremental improvements are underway. By refining GST, India can create a tax system that supports sustainable SME growth and contributes to inclusive economic growth.

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