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IMPACT OF GST ON MSMES AND INDIA'S FORMAL ECONOMY

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I picked this topic mostly because of the GST 2.0 news cycle around September last year. Every other article was about rate cuts and "relief for small businesses." And I realised I didn't actually know what GST had done to MSMEs beyond the one-line summary we all memorised for exams. "One nation, one tax." It subsumed VAT, excise, and service tax, and it expanded the tax base. Those are facts. They stop being useful the moment you ask a slightly harder question. That's basically what I tried to do here.

MSMEs matter. Not niche. By most estimates, they make around 30% of India's GDP and close to 45% of exports. They employ about 20 crore people. After agriculture, they are the biggest employer in the country. So whatever GST did to this sector, good or bad, it wasn't at the margins. It hit near the centre. Eight years since rollout on 1st July 2017, GST is still the tax people complain about most. And somehow it's the one they've quietly adjusted their entire business around. I wanted to understand both halves. I used whatever data and reports I could find instead of repeating the government's framing.

THE PROMISE ON PAPER

Before GST, an MSME making plastic parts in Gujarat had to deal with a ridiculous mix of taxes. Excise duty, VAT, service tax, octroi, entry tax, central sales tax, and state cesses. Each had its own return, its own deadline, its own inspector who could turn up and spoil your week. Moving goods across a state border often took longer because of tax checkposts than because of the actual distance. Sounds made up. But it wasn't.

GST's pitch was simple. Collapse all of that into one tax. Let credit flow across the supply chain through Input Tax Credit. Make the country one common market instead of twenty-nine mini ones. For MSMEs, there were two promises bundled together. First, compliance gets simpler. One tax instead of many. Second, and this is the part I find more interesting, GST would nudge informal firms into the formal fold without needing a new inspector. If you're unregistered, your registered buyer can't claim credit on what they bought from you. So formal firms would prefer formal suppliers. Staying informal becomes costly in business terms, not just legally risky. A market push toward formalisation.

WHERE THE THEORY MET THE ROAD

The first two or three years were rough. The GSTN portal crashed around filing deadlines with comic regularity. Small businesses that had only dealt with an income tax return suddenly needed monthly returns, HSN codes for products they'd never classified, and a reliable internet connection with someone who knew digital filing. Many MSMEs in smaller towns didn't have that. They started paying a CA every month. A new fixed cost that big firms barely notice and small ones feel immediately.

Then there was the working capital problem, which I think gets underdiscussed. Under the old system, many small manufacturers effectively didn't pay tax until goods were sold. Under GST, liability can kick in earlier. Refunds, especially for exporters or anyone caught in an inverted duty structure where inputs are taxed higher than outputs, got stuck for months. Money that should have been working capital sat with the government. Ask people in the textile clusters around Tirupur or Surat, and you will get an earful.

A QUICK CASE STUDY. THE HOSIERY UNIT THAT ALMOST DIDN'T SURVIVE YEAR ONE

To make this less abstract, take a composite example from Tirupur around 2017–18. Not naming an actual firm, but this pattern shows up a lot. A mid-sized hosiery manufacturer. About twenty-five workers. Mostly supplying exporters and a couple of domestic retail chains. Pre-GST, it paid excise only above a turnover threshold and dealt with VAT locally. Messy, but familiar. Post-GST, cotton yarn, its main input, was taxed at 18% while finished knitwear often fell under 5% to 12%. Classic inverted duty structure. Credit piled up faster than it could be used. Refunds that should have taken weeks dragged to eight or nine months early on.

They still had wages to pay, yarn to buy for the next order, and a bank that wasn't interested in lending against a "refund receivable from the government." Usually two options. Borrow at high informal rates to bridge the gap. Or scale down production and let a couple of workers go until the refund came. Multiply that across thousands of units in Tirupur, Ludhiana and Panipat, and you see why "GST hurt small manufacturers" isn't just an anecdote. It's a predictable result of taxing inputs higher than outputs in a labour-heavy, low-margin sector. It's also the exact problem GST 2.0 has tried to fix, which I will get to.

The government did try to soften some of this. The Composition Scheme lets small businesses with turnover up to ₹1.5 crore for goods, and lower for services, pay a flat low rate, about 1% for traders and manufacturers. You give up the right to claim input credit and avoid detailed ITC records[1]. Fine if you're tiny and selling to end consumers. Less useful if you sell up the chain to registered firms, because then you sit outside the ITC loop and the formalisation push gets blunted.

SO, DID FORMALISATION ACTUALLY HAPPEN?

I keep circling back to this. Popular commentary oversimplifies both sides.

The optimistic case has real numbers. GST registrations have grown a lot since 2017. As of April 2025, there were over 1.51 crore active taxpayers on the system, compared to roughly 65 lakh who migrated in at launch. Collections tell a similar story. Average monthly GST revenue was around ₹90,000 crore in 2017-18. By 2024-25 it had climbed to close to ₹1.84 lakh crore a

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[1] The Central Goods and Services Tax Act, No. 12 of 2017, § 10, Acts of Parliament, 2017 (India) (composition levy provisions); *see also* Composition Scheme Rules, Ministry of Fin., Cent. Bd. of Indirect Taxes & Customs, https://cbic-gst.gov.in.

month. Total collections for the year crossed ₹22 lakh crore, the highest ever[2]. Some of that is just growth and inflation. But a chunk is the tax base widening. You don't get consistent multi-year growth purely from existing taxpayers paying more. E-way bill generation, which tracks goods movement above a value threshold, is close to universal for inter-state trade now. Moving anything without one is genuinely impractical. None of this is accidental. It reflects real firms that used to operate under the radar now showing up in the net, at least partially, because holding a GSTIN became commercially necessary.

The skeptical case, and the one I lean toward, is that much of this is partial formalisation. A firm gets a GST number because it needs one to sell to a bigger registered buyer. But its operations - labour practices, bookkeeping, everything that isn't strictly tax-facing - stay informal. Getting a GSTIN is not the same as becoming a formal enterprise in the fuller sense. Regular payroll, EPF or ESI compliance, audited books. A huge share of India's roughly 6 crore MSMEs are still proprietorships or partnerships running on family labour[3]. GST registration pulls them into the tax net without necessarily pulling them into labour-law formality. So when rising GST registrations are cited as proof the economy is formalising, we should be precise about which slice of the story that measures.

There is also an uncomfortable possibility. Some of the "formalisation" GST produced might not be small firms growing into the tax net at all. It might be smaller, truly informal units losing business to slightly bigger, already-formal competitors who could absorb the compliance cost. If that happened at scale, it wouldn't look like a success in the overall data. It would look like quiet consolidation, informal jobs shrinking rather than turning into anything better.

THE EMPLOYMENT QUESTION NOBODY QUITE ANSWERS

This nagged at me while reading the reports. "Formalisation" is measured in tax terms, rarely in employment terms. The two don't move together as neatly as we'd like. A huge chunk of the MSME workforce remains informally employed. No written contracts, no EPF, no ESI, wages paid in cash. Whether the firm holds a GST number or not.

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[2] Press Release, Press Info. Bureau, Ministry of Fin., Gov't of India, *Record Gross GST Collection in 2024–25* (June 30, 2025), https://www.pib.gov.in/PressNoteDetails.aspx?id=154789&NoteId=154789&ModuleId=3.

[3] Press Release, Press Info. Bureau, Ministry of Micro, Small & Medium Enters., Gov't of India, *MSME Sector Accounts for 30.1% of India's GDP, 35.4% of Manufacturing and 45.73% of Exports in the Country: Union Minister for MSME* (2025), https://www.pib.gov.in/PressReleasePage.aspx?PRID=2142170&reg=3&lang=2.

GST was never really a labour-market tool. It formalises the sale, not necessarily the worker. Go back to that hosiery unit. It can be fully GST-compliant, filing returns on time, claiming credit correctly, and still pay tailors piece-rate in cash with zero job security or benefits. So when policymakers point to rising GST registrations as evidence the economy is formalising, be precise about what's being claimed. The tax net has widened. That matters for revenue. But it's different from improving job security for people who work inside these units. Mixing the two inflates GST's success.

Maybe GST-driven formalisation of firms eventually creates pressure to formalise labour too. Formal firms might find it easier to get credit, invest, and grow, which could make formal jobs more viable. It's a plausible chain. I haven't seen convincing Indian data tracing that through yet, so I wouldn't assume it just because it sounds tidy.

GST 2.0: A COURSE CORRECTION

This is where the story gets current. And where the last year matters. In September 2025, the GST Council pushed through what's called GST 2.0. Arguably the biggest structural change since rollout. The old four-slab structure, 5%, 12%, 18%, 28%, collapsed into basically two main slabs, 5% and 18%[4]. A steep 40% rate was carved out for sin and luxury goods. The compensation cess was scrapped. Around 200 items saw rate cuts. The number of goods taxed at the lowest slab nearly tripled.

A few things in this round speak directly to the problems above. Fixing inverted duty structures, the exact issue that strangled our hosiery unit's cash flow, matters more for small manufacturers than headline rate cuts. Faster refunds matter too. Provisional refunds of 90% upfront for exporters, effective November 2025, target the working-capital bleed MSMEs have complained about since 2017[5]. Whether this works smoothly on the ground, given the GSTN portal's track record, is another question. Too recent to have real data yet.

[4] Press Release, Press Info. Bureau, Ministry of Fin., Gov't of India, *GST Reforms 2025: Relief for Common Man, Boost for Businesses* (Sept. 2025), https://static.pib.gov.in/WriteReadData/specificdocs/documents/2025/sep/doc202594628401.pdf; *see also* Vasudha Mukherjee, *GST Council Clears 2-Slab Structure: What Gets Cheaper, What Gets Expensive*, Bus. Standard (Sept. 3, 2025, 11:14 PM IST), https://www.business-standard.com/economy/news/gst-council-two-slab-5-18-percent-what-gets-cheaper-expensive-sin-tax-125090301672_1.html.

[5] Vasudha Mukherjee, *GST Council Fast-Tracks Refunds Under Inverted Duty Structure: What to Know*, Bus. Standard (Sept. 4, 2025, 9:12 AM IST), https://www.business-standard.com/economy/news/gst-council-reforms-refunds-inverted-duty-structure-exports-125090400155_1.html; *see also* CBIC Instruction No. 06/2025-GST (Oct. 3, 2025) (Cent. Bd. of Indirect Taxes & Customs, India) (directing provisional sanction of 90% of refund claims under inverted duty structure, effective Nov. 1, 2025).

What I find interesting is that GST 2.0 is basically an admission that the original design underestimated how hard compliance would be for small businesses. You don't simplify slabs, fix inverted duty structures, and promise faster refunds unless the earlier version was creating real drag. Not a criticism from hindsight so much as how big policy usually works. You learn, and you tweak. Nobody could have predicted all the knock-on effects on six crore very different firms from a table in Delhi.

THE SECTORAL PICTURE

Aggregate numbers hide a lot of variation that matters. Labour-intensive, low-margin sectors like textiles, leather, handicrafts and small-scale food processing felt GST's compliance burden hardest. Their margins leave no room to absorb a new fixed cost. Many run on informal, cash-based supply chains that GST's paper trail sits awkwardly on top of. Sectors that were already more organised, like auto components, pharma and larger contract manufacturers, absorbed GST with less pain. In some cases, they benefited from cascading taxes disappearing and goods moving more smoothly across state lines.

Services MSMEs are different. A small IT services firm or design studio selling pan-India or exporting found GST's unified structure a lot simpler than the old service-tax-plus-VAT confusion about what counted as a good versus a service. If you want a place where GST's formalisation logic worked cleanest, I'd point here before manufacturing.

WHERE I LAND

I don't think GST has been the disaster its harshest critics say. Nor has it been the formalisation win the government's messaging suggests. It's been a difficult, costly adjustment for millions of small firms. Layer that on top of demonetisation and then COVID in quick succession. Three shocks to informal-sector cash flow in about three years. That gets underweighted when we judge GST by itself. At the same time, the logic behind ITC-driven formalisation is sound. The tax base has widened. And GST 2.0's fixes show the system can learn, which is more than you can say for a lot of policy.

What I'd like to see more of is detailed data that separates "got a GST number" from "became formal" in the fuller sense - payroll compliance, credit access, job security. Until we measure that distinction properly, both cheerleaders and critics of GST end up talking past each other while quoting the same overall numbers. The honest answer is less dramatic than either story. A messy, unfinished transition that cost small businesses real money and time, and that is also slowly pulling more of India's economy into the open.