

Goods and Services Tax and India's MSMEs: Compliance, Formalisation and the 2025 Rate Reform

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Abstract

The Goods and Services Tax (GST), introduced in India on 1 July 2017, replaced fragmented central and state indirect taxes with a destination-based value added tax. Its effects on micro, small and medium enterprises (MSMEs) remain debated. This paper reviews international research on value added taxation and informality together with Indian evidence on GST and MSMEs, and examines the 2025 reform that rationalised GST into a two-rate structure. Using a structured narrative review of peer-reviewed studies, working papers and official data, the paper organises the evidence around three themes: the formalisation effects of value added taxes, the compliance burden on small firms, and the role of digital tax administration. The review finds that GST has expanded the formal tax base substantially: registered taxpayers rose from 65 lakh in 2017 to more than 1.51 crore by 2025, and gross collections doubled from ₹11.37 lakh crore in 2020-21 to ₹22.08 lakh crore in 2024-25. International evidence shows that the invoice trail in value added taxes encourages compliance along supply chains, but also that tax registration choices spread through supplier networks, disadvantaging unregistered small firms. Indian survey evidence points to working capital strain from blocked input tax credits and the costs of formalising informal practices. The 2025 reform, with rates of 5 and 18 per cent and faster registration and refunds, addresses some of these concerns. The paper proposes a research agenda on supply chain inclusion, working capital, e-invoicing and the effects of the rate reform.

Keywords: - Goods and Services Tax, MSMEs, Formalisation, Tax compliance, India

I. INTRODUCTION

Micro, small and medium enterprises occupy a central place in India's economy. They account for a large share of manufacturing output, exports and non-farm employment, and many operate at the boundary between the formal and informal sectors. The Udyam Registration Portal and the Udyam Assist Platform, which register enterprises for access to government support, together covered nearly 9 crore enterprises by July 2026, many of them informal micro-enterprises outside the GST and income tax systems.

The Goods and Services Tax, introduced on 1 July 2017, was one of the most significant reforms of India's tax system. It subsumed a large number of central and state levies, including excise duty, service tax and state value added taxes, into a unified destination-based tax with seamless input tax credit across the supply chain. Its proponents expected it to create a common national market, reduce cascading taxes and encourage formalisation by linking the tax liability of each firm to verified invoices from its suppliers.

The tax base has expanded considerably. The number of registered GST taxpayers grew from 65 lakh in 2017 to more than 1.51 crore by 2025, and gross collections doubled from ₹11.37 lakh crore in 2020-21 to ₹22.08 lakh crore in 2024-25. At the same time, MSMEs have reported significant difficulties, including frequent changes in rules, compliance costs, technological requirements and delays in input tax credit and refunds.

In September 2025, the GST Council approved a major rationalisation of rates, replacing the earlier multi-rate structure with a merit rate of 5 per cent and a standard rate of 18 per cent, together with a demerit rate of 40 per cent for selected goods, effective 22 September 2025. The reform also introduced faster registration and provisional refund measures aimed partly at small businesses.

This paper addresses the following research question: what does existing evidence suggest about the effects of GST on MSMEs, and to what extent does the 2025 reform address the challenges identified? It contributes by linking international

research on value added taxation and informality with Indian evidence on GST, and by situating the 2025 reform within this evidence. The rest of the paper is organised as follows. Section 2 reviews the literature, Section 3 describes the method, Section 4 presents the findings, Section 5 discusses implications, and Section 6 concludes.

II. LITERATURE REVIEW

2.1. Value added taxation and economic structure

The value added tax has spread to more than 160 countries. Keen and Lockwood (2010) find that its adoption has generally been associated with an increase in the effectiveness of revenue collection, although the gains vary with the structure of the economy and are weaker in countries with large agricultural or informal sectors. The design of a value added tax matters for small firms because the tax is collected in stages: each registered firm charges tax on its sales and claims credit for tax paid on its inputs.

This structure creates what De Paula and Scheinkman (2010) describe as chain effects. Because a registered firm can claim input tax credit only on purchases from registered suppliers, firms that are formal tend to buy from and sell to other formal firms, while informal firms cluster together. Informality can therefore spread along supply chains, and the decision of one firm to register affects the incentives of its trading partners.

2.2. Thresholds and the compliance burden

Most value added tax systems exempt small firms below a turnover threshold. Kanbur and Keen (2014) show that thresholds create several groups of firms, including those that are legitimately below the threshold, those that should register but do not, and those that register but under-report. The choice of threshold involves a trade-off between the administrative and compliance costs of covering many small firms and the revenue and competitive distortions that arise when firms remain outside the system.

India's GST includes such features. Firms with turnover below specified thresholds need not register, while a composition scheme allows small firms to pay tax at a low flat rate on turnover with simpler compliance but without input tax credit. Quarterly return filing with monthly payment was introduced in 2021 for smaller taxpayers. These provisions reduce compliance costs, but firms that remain outside the regular system may lose business from registered buyers who cannot claim credit on their purchases.

2.3. Information, enforcement and digital administration

A distinctive feature of the value added tax is the paper trail created by invoices. Using a randomised experiment in Chile, Pomeranz (2015) shows that increasing the perceived probability of audit raised reported transactions, with effects transmitted up the supply chain through the invoice trail, which confirms that the tax has a self-enforcing element. Naritomi (2019) finds that a Brazilian programme rewarding consumers for requesting receipts increased reported retail sales, demonstrating the value of third-party information. Okunogbe and Pouliquen (2022) show that the introduction of electronic tax filing in Tajikistan reduced bribe payments and compliance costs for firms, although effects on revenue varied.

India has invested heavily in digital tax administration. GST returns are filed online, input tax credit is matched against supplier filings, and electronic invoicing is mandatory for businesses with aggregate turnover above ₹5 crore since 1 August 2023. These systems strengthen the information trail but also raise the technological and procedural demands on smaller firms.

2.4. Indian evidence on GST and MSMEs

Evidence from India's earlier state value added taxes and from GST highlights the importance of supply chains. Using data on 4.8 million supplier-client pairs from West Bengal, Gadenne and Nandi (2023) find that the tax system distorted firms' sourcing decisions and that firms' registration choices were strategically linked to those of their trading partners. They argue that exempting inter-firm sales of small firms could benefit SMEs at little cost in revenue.

Survey evidence documents the experience of small firms under GST. Ghosh (2022) finds that GST introduced formal practices into the daily operations of MSMEs but also disrupted established informal arrangements, with adverse effects on vulnerable enterprises and their workers. In a survey of 400 MSMEs, Sureka and Bordoloi (2024) find that blocked credits and difficulties in claiming input tax credit raised working capital requirements and operating costs.

2.5. Research gap

The international literature provides a strong framework for understanding how value added taxes affect informality and compliance, and Indian studies document the experience of MSMEs. However, most Indian evidence is based on surveys from the early years of GST, and the 2025 rate reform has not yet been examined. This review seeks to integrate these strands and assess the reform in light of the evidence.

III. METHODS

The study adopts a structured narrative review design, combining peer-reviewed research and working papers with official data and Council decisions. This design is appropriate because the evidence spans public finance, development economics and small business research, and because recent policy changes are documented mainly in official sources.

3.1. Sources and selection

Academic studies were identified through Google Scholar, RePEc/IDEAS and SSRN using combinations of the terms "value added tax", "GST", "informality", "tax compliance", "MSME", "input tax credit", "e-invoicing" and "India". Official sources included GST collection statistics, government statements on the taxpayer base and Udyam registrations, and the

decisions of the 56th meeting of the GST Council. Studies were included if they (a) analysed value added taxation, informality, compliance or GST using quantitative or qualitative evidence; (b) appeared in peer-reviewed journals, recognised working paper series or official publications; and (c) were relevant to the Indian context. Selection was purposive, prioritising studies with credible research designs.

3.2. Analysis

Studies were coded by setting, data, method and principal findings and grouped into themes. Official data were analysed descriptively, and the 2025 reform was assessed against the challenges identified in the literature. Because the study relies entirely on published material, no primary data were collected and ethical approval was not required.

IV. RESULTS

4.1. Expansion of the GST base

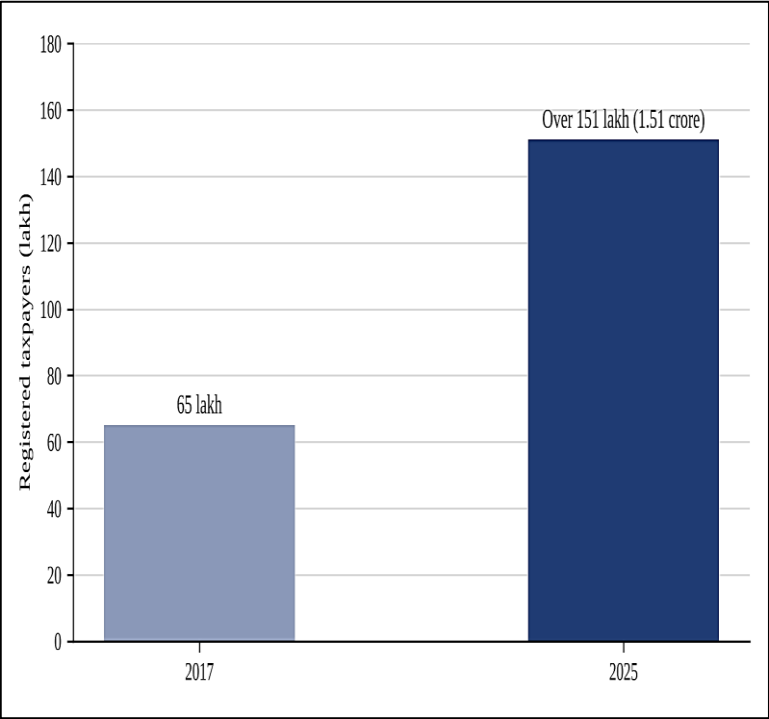
Table 1 summarises key indicators. Both the number of registered taxpayers and gross collections have grown substantially since GST was introduced, which is consistent with formalisation of at least part of the economy. Figure 1 illustrates the growth in the registered taxpayer base.

Table 1. Key Indicators of GST and MSME Formalisation in India

Indicator	Earlier value	Latest value	Source
Registered GST taxpayers	65 lakh (2017)	Over 1.51 crore (2025)	Government statements
Gross GST collections	₹11.37 lakh crore (2020-21)	₹22.08 lakh crore (2024-25)	Government data
Average monthly gross collection	₹1.68 lakh crore (2023-24)	₹1.84 lakh crore (2024-25)	Government data
Enterprises on Udyam and Udyam Assist	–	Nearly 9 crore (July 2026)	Ministry of MSME
E-invoicing threshold (aggregate turnover)	₹500 crore (Oct 2020)	₹5 crore (Aug 2023)	CBIC notifications

Source: Compiled by the author(s) from official GST statistics and government statements as reported in 2025-2026, Ministry of MSME statements (2026) and CBIC notifications.

Figure 1: Registered GST Taxpayers, 2017 and 2025



Source: Government data as reported in June 2025. Figures in lakh taxpayers.

4.2. Synthesis of evidence

Table 2 synthesises the principal studies reviewed. Two patterns stand out. First, the information trail created by value added taxes promotes compliance, especially when supported by digital systems. Second, the same chain structure that encourages compliance can disadvantage small firms that remain outside the system and can impose working capital costs on those inside it.

Table 2. Synthesis of Selected Studies on Value Added Taxation and Small Firms

Study	Setting and data	Principal finding
De Paula & Scheinkman (2010)	Brazil; firm-level survey	Informality spreads along supply chains through value added tax chain effects
Keen & Lockwood (2010)	Cross-country panel	VAT adoption generally raised revenue effectiveness, less so with large informal sectors
Kanbur & Keen (2014)	Theoretical analysis	Thresholds create distinct groups of compliant and non-compliant firms
Pomeranz (2015)	Chile; randomised audit experiment	Invoice trail transmits enforcement up the supply chain
Naritomi (2019)	Brazil; consumer receipt incentive programme	Third-party information from consumers raised reported sales
Ghosh (2022)	India; survey of MSMEs	GST introduced formal practices but disrupted informal arrangements of vulnerable firms
Gadenne & Nandi (2023)	India; 4.8 million supplier-client pairs	Tax system distorts sourcing; registration choices linked across networks
Sureka & Bordoloi (2024)	India; survey of 400 MSMEs	Blocked input tax credit raises working capital needs and costs

Source: Compiled by the author(s).

4.3. The 2025 rate reform

The 56th meeting of the GST Council on 3 September 2025 approved a rationalised structure with a merit rate of 5 per cent, a standard rate of 18 per cent and a demerit rate of 40 per cent for selected goods, effective 22 September 2025. The Council also approved trade facilitation measures relevant to small firms. Registration is to be granted automatically within three working days for low-risk applicants and those with expected monthly output tax liability below ₹2.5 lakh. Provisional refunds of 90 per cent were introduced for zero-rated supplies and cases of inverted duty structure from 1 November 2025, and registration procedures were simplified for small suppliers selling through e-commerce operators across states. The GST Appellate Tribunal was also scheduled to begin operations.

Measured against the literature, these changes address several MSME concerns. A simpler rate structure reduces classification disputes and compliance complexity. Faster refunds for inverted duty structures respond directly to the working capital problems documented by Sureka and Bordoloi (2024). Automated registration lowers entry costs into the formal system. However, the reform does not directly address the supply chain disadvantage faced by small unregistered and composition firms, which cannot pass input tax credit to registered buyers (Gadenne & Nandi, 2023).

V. DISCUSSION

The findings suggest that GST has contributed to a substantial expansion of India's formal tax base, consistent with international evidence on the self-enforcing properties of value added taxes (Pomeranz, 2015). The doubling of collections and the more than doubling of registered taxpayers indicate that the design of GST, combined with digital administration, has drawn many firms into the formal system.

At the same time, the chain structure of GST has distributional consequences for small firms. As De Paula and Scheinkman (2010) and Gadenne and Nandi (2023) show, firms that remain outside the system may be excluded from supply chains led by registered firms, while firms inside the system face compliance and working capital costs. The Indian survey evidence from Ghosh (2022) and Sureka and Bordoloi (2024) suggests that these costs have been significant for vulnerable enterprises. The challenge for policy is to preserve the enforcement benefits of the invoice trail while reducing the burden on small firms.

The findings carry implications for several groups. For policymakers, the 2025 reform is a step towards simplicity, but further measures could include timely and predictable refunds, clearer rules on blocked credits, and approaches that allow small composition firms to participate more fully in supply chains. For MSMEs, investment in digital accounting and timely filing can reduce the risk of credit mismatches and improve access to formal buyers and credit, since GST records increasingly serve as evidence of business activity. For large firms and e-commerce platforms, supporting the compliance of small suppliers can strengthen supply chain resilience.

The review has limitations. Much of the Indian evidence is based on surveys with limited samples, and causal evidence on GST and MSME outcomes remains scarce. Official figures on collections and taxpayers do not distinguish growth due to formalisation from growth due to inflation, economic expansion and enforcement. The 2025 reform is recent, and its effects cannot yet be assessed. Finally, as a narrative review, the study involves judgement in selecting and interpreting evidence.

VI. CONCLUSION

This paper reviewed evidence on the effects of GST on India's MSMEs. It finds that GST has substantially expanded the formal tax base and that its invoice-based design and digital administration promote compliance. However, the chain structure of the tax and its procedural demands have imposed costs on small firms, particularly through blocked input tax

credit, working capital strain and the disadvantage faced by firms outside the regular system. The 2025 rate rationalisation and associated facilitation measures address several of these concerns but leave others unresolved.

Several areas merit further research. First, studies using GST return and e-invoice data could measure how supply chain links between registered and unregistered firms have changed since 2017. Second, research could estimate the effects of the 2025 rate reform on prices, compliance and MSME margins using difference-in-differences designs across affected products. Third, studies could examine whether faster refunds have eased working capital constraints for exporters and firms with inverted duty structures. Fourth, research could assess the use of GST data in lending to MSMEs and its effects on credit access. Fifth, comparative analysis of the composition scheme could identify ways to include small firms in input tax credit chains without excessive compliance burden. Addressing these questions would help ensure that GST supports both revenue and the growth of India's small enterprises.

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