



Impact of GST on Small Business: Evidence from a Survey of Small Enterprises

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Abstract: Goods and Services Tax (GST) was implemented in India in July 2017, which replaced a complex network of central and state indirect taxes with a single indirect tax based on the place of supply with an input tax credit mechanism by matching the invoice. The impact of such a reform is greatest, especially for small businesses, due to the combination of fixed costs of compliance and limited administrative capacity of small business. To analyse the effects of GST on small businesses with respect to (1) compliance cost, input tax credit (ITC) and working capital, (2) formalization of the market, and (3) perceived performance of the business and to find the characteristics of the firms that influence the effects. The cross-sectional survey was done with 180 small business owners or accounts managers that are registered for the GST in [city/district] by administering a structured questionnaire with 5-point Likert items and recall-based quantitative measures both before and after the implementation of the GST. Descriptive statistics, paired-samples t-tests, correlation and multiple linear regression were used to analyse data. Monthly compliance cost increased from a mean of ₹2,135 to ₹3,432 ($p < 0.001$), and tax-related work increased from 6.3 to 9.8 hours per month ($p < 0.001$), the increase being greatest in the smallest companies. Meanwhile, the number of separate tax registrations decreased and purchases from registered suppliers, and formally invoiced sales, increased dramatically. The working-capital cycle ($r = 0.72$) was positively associated with the ITC realization delay. Compliance cost burden ($\beta = -0.29$) and Digital readiness ($\beta = 0.31$) had the highest correlation with perceived performance impact in regression analysis. GST has provided structural benefits for small businesses in the form of less cascading, a one-time registration and increased formalization, alongside recurring compliance costs and credit-linked liquidity pressures.

The small companies would be able to keep the advantages without the burden thanks to simplified filing, faster processing of credit and withholding/excess payments, and targeted digital support.

Keywords: Goods and Services Tax; small business; MSME; compliance cost; input tax credit; formalization; tax reform

1. INTRODUCTION

1.1 Background

The VAT system is now the most popular indirect tax system in the world and has been recognised as being both revenue productive and neutral in terms of number of stages in a production chain [1]. It is characterised by the paper trail generated by the invoice matching, which creates a certain degree of self-enforcement and each buyer has an incentive to ask for an appropriate invoice from the seller [2]. The Goods and Services Tax subsumed excise duty, service tax, value added tax, entry tax and various cesses under it into a single tax levied at the point of actual transaction between the Union and state governments on 1 July 2017 in India. Initial experience in India indicates that administration has become more

efficient, but with significant variation in performance between States [3].

1.2 Why Small Businesses Are Differently Affected

Although dominated by small enterprises, they account for a significant proportion of employment and have low levels of access to formal finance and any accounting expertise within the firm [4] and operate with thin margins. For them there are two aspects of tax design that are significant. Much of the cost of compliance (such as software, professional fees and the owner's time) is not related to turnover; this means that the smallest businesses will bear the brunt of the cost. Second, the prevalence of informality is high at the small end of the size distribution, and firms are operating somewhere on the continuum between the extremes of informality to informality [5, 6]. A reform



that increases the visibility of transactions can thus affect both the tax paid and the decision to formalise and the extent to which it is formalised.

1.3 Channels Identified in the Literature

Policy analysis of tax administration suggests three ways in which a GST type reform impacts on small firms. The first is the compliance cost channel: there are fixed compliance costs and size-based thresholds give the incentives for firms to stay small or just under the registration line, largely due to fixed compliance costs, not the rate of the tax itself [7] (8, (9)). Additionally, restricted administrative capacity also drives governments towards instruments that don't necessarily promote production efficiency for the sake of revenue (e.g. turnover taxation) [10] and monitoring intensity has a clear impact on reported activity in smaller firms [11].

The second channel is the credit-chain and formalization channel. Input tax credit can be claimed only on purchases from registered suppliers, thus the registration trickles down the supply chain, and companies dealing with formal suppliers are forced into the formal sector [12]. Mechanisms to strengthen the invoice trail increase the reported sales materially [13] but the welfare impact of taxing intermediate transactions where informality is high is not unanimously agreed upon [14]. The third channel is the performance channel: formalization can lead to better performance from the firm where it facilitates access to credit, larger customers and public procurement [15], [16], and digital tax infrastructure can reduce the cost of compliance and increase the detection [17]. The net impact on a small company would vary according to which of these channels is predominant in its specific market.

1.4 Research Gap and Objectives

The majority of the evidence available in India regarding GST and small business is either aggregate collection/registration evidence or descriptive evidence, based on secondary sources. Largely, the focus has been on the firm level to measure increases in compliance activity, the link between credit delays and liquidity pressures, and the factors that lead to a positive outcome for the firm from the reform. The present study aims to fill that gap with the following objectives:

- To measure the impact on tax-compliance cost and administrative burden of small business following introduction of GST.

- To evaluate the impact of GST on input tax credit realization and working capital cycle.
- To review the formalisation, based on registered-supplier purchases and formally invoiced sales.
- To find out what factors determine the perceived effect of GST on business performance.

1.5 Hypotheses

- H_1 : There is a significant increase in compliance cost and time spent on tax work in the post-GST period compared to pre-GST period.
- H_2 : Delay in ITC realization is positively associated with the length of the working-capital cycle.
- H_3 : Compliance cost burden is negatively, and digital readiness positively, associated with the perceived impact of GST on business performance.

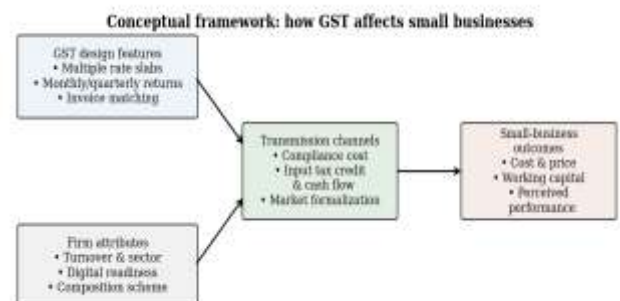


Fig. 1. Conceptual framework linking GST design features and firm attributes to small-business outcomes.

2. RESEARCH METHODOLOGY

2.1 Design and Study Area

The study adopted descriptive, cross-sectional design and pre-post design (recall). Data collection was conducted in the city/district, state, from [month, year] to [month, year]. The sampling frame comprised GST registered enterprises with annual sales up to ₹5 crore whose details were sourced from trade association members' list and from market directories.

2.2 Sample and Sampling

180 enterprises were sampled, stratified by sector (trading, manufacturing and services) and stratified by turnover slab with the purpose of ensuring micro units



were not under-represented. The respondents were proprietors, partners or accounts managers who had been associated with the firm for more than five years to provide details on the pre-GST and post-GST periods. 214 firms were approached and 180 gave some responses (84.1% response rate).

2.3 Instrument and Reliability

The questionnaire consisted of four sections – Firm Profile; Quantitative Recall Items – Pre-GST and Post-GST (Compliance Cost, Hours spent, Number of Registrations, Purchase from registered suppliers, Sales formally invoiced); Five-point Likert Scales (Perceived benefits, Perceived challenges, Digital readiness, Perceived performance impact); and Open-ended suggestions. The content validity was evaluated by two academic specialists and two working tax practitioners and a pilot test was carried out with 20 firms which did not form part of the sample. All constructs were found to have acceptable internal consistency (Table 1), with alpha values being considered acceptable and as suggested by [18] dependent on scale length and dimensionality. All the data were obtained from one informant per firm, and therefore, the following procedural remedies were used to reduce common method bias: assurance of anonymity, separation of predictor and outcome items, and mixed order of items [19].

Table 1. Constructs, items and internal consistency

Construct	Items	Cronbach's α	Mean $\pm$ SD
Perceived benefits of GST	5	0.812	3.81 $\pm$ 0.61
Perceived compliance challenges	5	0.847	4.00 $\pm$ 0.58
Compliance cost burden	4	0.791	3.90 $\pm$ 0.75
Digital readiness	4	0.803	3.10 $\pm$ 0.85
Perceived performance impact	3	0.774	3.02 $\pm$ 0.64

2.4 Data Analysis

The data were analysed using SPSS. Firm characteristics and Likert responses were summarised using descriptive statistics. Pre-GST and post-GST values were compared for the quantitative measures using paired-samples t-tests and Cohen's d was reported as the effect size. The ITC delay–working capital relationship was analyzed using the Pearson correlation. Multiple linear regression, estimated using the ordinary least squares method, was used to model

perceived performance impact to compliance cost burden, digital readiness, ITC realization delay, use of the composition scheme and natural logarithm of annual turnover. Linearity, homoscedasticity of residuals, normality of residuals and absence of multicollinearity (all VIF<2) were checked. A p value of < 0.05 was used for the definition of significance.

3. RESULTS

3.1 Profile of Surveyed Enterprises

A description of the sample is included in Table 2. The largest number of trading firms, with a little over a third under the composition scheme, had turnover less than ₹1 crore. Two thirds used the services of an external tax practitioner to prepare their returns.

Table 2. Profile of surveyed small enterprises (n = 180)

Characteristic	Distribution, n (%)
Sector	Trading 82 (45.6); Manufacturing 54 (30.0); Services 44 (24.4)
Annual turnover	< ₹20 lakh 38 (21.1); ₹20–40 lakh 49 (27.2); ₹40–100 lakh 57 (31.7); > ₹100 lakh 36 (20.0)
Registration type	Regular 112 (62.2); Composition scheme 68 (37.8)
Return filing	External tax practitioner 121 (67.2); In-house or self-filed 59 (32.8)
Years in business	≤ 10 years 61 (33.9); > 10 years 119 (66.1)

3.2 Perceived Benefits and Challenges

The statements for a single registration instead of several, and for easier trade cross-state and better record keeping received the highest ratings, while the highest ratings for the lowest were for better access to formal credit. On the challenge side, the most scores were given to the cost of professional assistance and return filing. (Fig. 2) Even those that did recognise the structural benefits perceived a net burden (with the overall mean for challenges being 4.00 and the overall mean for benefits being 3.81).

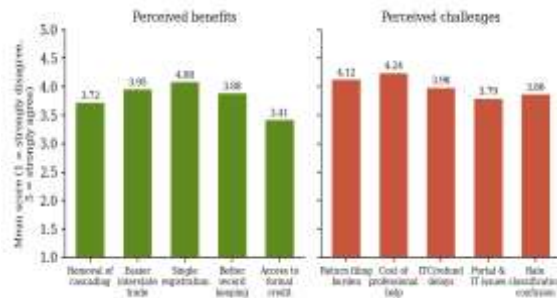


Fig. 2. Mean agreement scores for perceived benefits and perceived challenges of GST.

3.3 Change in Compliance Cost and Formalization

Results of all six recall measures are significant between the two periods (Table 3). The monthly compliance cost increased by approximately 61%, the time spent on tax work by 56% and the number of separate tax registrations decreased from 2.5 to 1.1. The formalization indicators followed the course that was suggested in the credit-chain argument: The sales to formally registered suppliers increased by about 19 percentage points, and the purchases from formally registered suppliers increased by about 23 percentage points. The working-capital cycle increased slightly by 8 days. As can be seen from Figure 3, the compliance cost of firms with less than ₹20 lakh turnover increased at a higher rate (+92%), whereas the increase in compliance cost of the others with more than ₹1 crore turnover was the least (+46%), which indicates that the incidence of fixed compliance cost is regressive.

Table 3. Pre-GST and post-GST comparison of firm-level measures (paired-samples t-test, n = 180)

Measure	Pre-GST (mean ± SD)	Post-GST (mean ± SD)	t	p	Cohen's d
Monthly tax-compliance cost (₹)	2,135 ± 762	3,432 ± 1,325	24.92	<0.001	1.86
Owner/staff time on tax work (hours per month)	6.3 ± 1.9	9.8 ± 3.7	22.52	<0.001	1.68
Number of separate tax registrations	2.5 ± 0.8	1.1 ± 0.5	32.41	<0.001	2.42
Share of purchases from registered suppliers (%)	49.2 ± 16.1	68.4 ± 23.3	24.51	<0.001	1.83
Share of sales invoiced formally (%)	55.6 ± 16.5	78.6 ± 24.8	27.08	<0.001	2.02
Working-capital cycle (days)	37.9 ± 11.9	45.5 ± 15.1	13.65	<0.001	1.02

df = 179 for all comparisons. Pre-GST values are respondent recall estimates.



Fig. 3. Monthly compliance cost by turnover slab before and after GST, with percentage increase.

3.4 Input Tax Credit and Working Capital

The average time taken to avail the input tax credit was 34 days and 41% of companies had blocked credit or a pending refund at least once in the last year. The working-capital cycle was also positively and significantly correlated with the ITC realization delay



($r = 0.72$, $p < 0.001$; Fig. 4), which is in line with H₂. Companies opting for the composition scheme (which involves not claiming input tax credit while enjoying a reduced rate of tax and simpler tax filing procedures) recorded a shorter working-capital cycle but also a smaller proportion of registered-supplier customer types, in keeping with the trade-off involved.

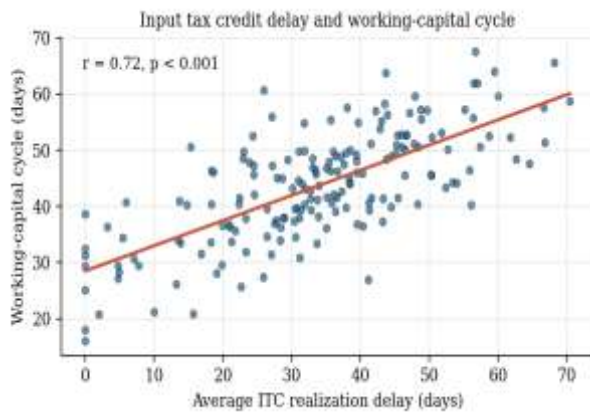


Fig. 4. Relationship between ITC realization delay and the working-capital cycle.

3.5 Determinants of Perceived Performance Impact

The regression model was significant ($F(5, 174) = 11.83$, $p < 0.001$) and explained 25.4% of the variance in perceived performance impact (adjusted $R^2 = 0.232$). The coefficient of compliance cost burden was highly negative and digital readiness highly positive, which was supportive of H₃. Firms that had longer ITC delays had a less favourable perception, and firms that were part of composition-scheme firms reported a slightly more favourable perception. Once these variables were controlled for, turnover was not significant, indicating that capability and process factors are more important than measures of firm size alone (Table 4).

TABLE 4. Determinants of perceived performance impact (OLS regression, $n = 180$)

Predictor	B	SE	t	p
Constant	3.061	0.377	8.12	<0.001
Compliance cost burden	-0.293	0.068	-4.28	<0.001
Digital readiness	0.307	0.053	5.73	<0.001
ITC realization delay (days)	-0.0075	0.0030	-2.48	0.014
Composition scheme (1 = yes)	0.191	0.093	2.06	0.041
Log annual turnover	0.032	0.062	0.52	0.603

Dependent variable: perceived performance impact (1–5). $R^2 = 0.254$; adjusted $R^2 = 0.232$; all VIF < 2.

4. DISCUSSION

4.1 Interpretation of Findings

The findings are a reform that has truly boushie effects for small business. On the other hand, combining several levies into a single registration and the discipline of invoice-based record keeping were widely recognized and the fact that the number of registered-supplier purchases and formally invoiced sales did increase suggests the path towards formalization was being taken. Conversely, compliance costs and administration workload increased significantly, with the percentage growth being highest for the smallest companies suggesting the typical increasing proportion of fixed compliance costs [7], [8]. The relationship between credit delays and the increase in the working capital cycle identifies the mechanism by which, despite its being an otherwise neutral tax, it becomes a liquidity constraint for firms facing short-term credit constraints [4].

4.2 Relation to Existing Evidence

The formalization results can be explained by the chain-effect logic under which the status of the registers is passed on within the supply chain and by evidence of how much the invoice trail is strengthened by increasing the number of reported transactions [2] [13]. The regressive incidence of compliance cost and the appeal of simplified schemes also resonates with research identifying that size-based thresholds and turnover-based instruments have an impact on firm actions primarily through compliance costs, but not tax rates [9, 10]. Digital readiness is strong also in the context of evidence that digital solutions in tax administration can either lower the cost of compliance or increase it, depending on the capability of the taxpayer [17]. Finally, the mixed findings are consistent with the larger scholarly literature indicating that formalization will have a positive impact only when it provides tangible benefits, such as credit and larger customers [15], [16].

4.3 Policy Implications

- Minimise the number of times that firms have to file and deliver a meaningful "one-off" quarterly return with pre-filled data for firms with a below-defined turnover threshold.
- Improve credit and refund procedures to ensure timely gratification of small suppliers, and to provide automatic credit and refunds after a fixed period if the period is



exceeded, to safeguard the working capital of small suppliers.

- Eliminate unacceptable supplier-side default risk, even if a supplier does not file, so that a buyer's credit is not rejected.
- Support digital and accounting capability development via trade associations as digital readiness was the most positive predictor of a positive experience.
- Review composition scheme for firms that want to keep it simple so they don't end up on the losing side of business-to-business supply chains.

4.4 Limitations

Pre-GST values are based on the respondent recall over a few years and may be prone to recall and attribution bias as other changes such as demonetisation and the pandemic were also impacting the period studied. The sample was purposive and limited to one urban area and only registered firms were sampled. It was obtained from one respondent per firm and the cross-sectional design does not allow for causal inferences; this is not possible with panel data or administrative tax records.

5. CONCLUSION

GST has impacted the small business environment in two ways. It has streamlined the procedure of indirect taxes, reduced cascading effects and brought small businesses into the formality. Meanwhile, it has increased the ongoing burden and expense of compliance, particularly for smaller businesses, and has also placed the working capital of such businesses at risk of not being available to meet their expenses until input tax credit is realized. The experience of an individual firm is least dependent on its size, but instead on its digital and accounting capability and the cost associated with compliance. Reducing the cost of compliance, speeding up credit and refunds and investing in the capacity of small taxpayers would ensure that the structural benefits of the reform would go to the firms who would ultimately bear the cost of the reform.

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