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The Impact of GST on the Indian Economy and Informal Sector

Hriday Sharma
hriday.sharma.academic@gmail.com

ABSTRACT

The introduction of the Goods and Services Tax (GST) in India in July 2017 was one of the country's largest indirect tax reforms, intended to simplify the tax system, remove the cascading 'tax on tax' effect, and create a single national market. Most existing research on GST looks at its effects on the formal sector and on consumers; comparatively little has been written about its effects on India's informal sector and the small, unincorporated businesses within it. This paper focuses on that gap.

Using secondary data - government surveys and databases (including the RBI Handbook of Statistics on the Indian Economy and the Ministry of Statistics and Programme Implementation's Annual Survey of Unincorporated Sector Enterprises, or ASUSE), academic literature, and policy reports - the paper looks descriptively at how GST's compliance requirements, working-capital effects, and firm-size incentives have played out in the informal sector. Economy-wide trends in indirect tax revenue, GDP, and inflation are reported only as background context, not as separate causal claims.

Between 2015-16 and 2022-23, the number of unincorporated enterprises rose slightly while informal-sector employment fell slightly, alongside literature reporting higher compliance costs, more frequent filing, and delays in input tax credit refunds. Because GST's introduction coincided with demonetisation and the COVID-19 pandemic, and because this study is descriptive rather than causal, these patterns are treated as associations rather than as evidence that GST caused them. The paper also argues that a rise in unincorporated enterprises is not the same thing as formalisation, and that more informal-sector-specific data is needed before firmer conclusions can be drawn.

Keywords: Goods and Services Tax (GST), Informal Sector, Small Businesses and MSMEs, Indirect Taxation Reform, Formalisation

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INTRODUCTION

GST, or Goods and Services Tax, is a form of indirect taxation introduced in India on 1 July 2017. It combined several existing taxes, including Value Added Tax (VAT), into a single structure, often summarised by the slogan 'One Nation, One Tax'. One of its stated aims was to remove the cascading 'tax on tax' effect, where goods and services had previously been subject to multiple layers of indirect taxation that increased their final price. GST has affected every part of the Indian economy, but most existing research focuses on its effects on the formal sector and on consumers.

Before GST, India's indirect tax system consisted of several overlapping central and state-level taxes, which created administrative complexity and led to different effective tax rates across states. GST was introduced to simplify this structure into a single, uniform tax applied nationally. Supporters of the reform have argued that this helped unify India's domestic market and made the country's tax system easier for international investors and trading partners to understand; this paper does not test that broader claim directly, and focuses instead on a narrower question, described below.

GST was discussed for nearly two decades before its implementation. The idea of a unified tax system was first proposed in 2000 under then-Prime Minister Atal Bihari Vajpayee and remained a recurring topic in Parliament. The Kelkar Task Force on Indirect Taxes made several recommendations for a GST model between 2002 and 2004. An official proposal to implement GST by April 2010 was put forward in 2006 by then Union Finance Minister P. Chidambaram, but this was delayed and ultimately shelved amid concerns from manufacturing states about constitutional flexibility and revenue security. A renewed and ultimately successful effort began in 2014, with all necessary approvals completed by the end of 2016, allowing GST to take effect on 1 July 2017.

India's informal sector refers to economic activity that takes place outside formal legal and regulatory frameworks. It consists mainly of small-scale businesses, including street vendors, household enterprises, and self-employed individuals. Work in the informal sector is often associated with lower wages, limited job security, and the absence of formal employment contracts or social security coverage. Despite operating outside formal institutional structures, the informal sector accounts for a substantial share of India's workforce and of its overall economic output.

This paper's central question is how the introduction of GST has affected India's informal sector and its small, unincorporated businesses - a segment that is estimated to contribute 40-50% of India's annual GDP, employs a large share of the workforce, and remains comparatively understudied next to the formal sector and consumer-facing effects of GST that dominate the existing literature. Trends in indirect tax revenue, GDP, and inflation are reported later in this paper only as macroeconomic background against which the informal-sector evidence can be read - they are not treated as separate research questions, and no claim is made that GST caused any particular change in them. The analysis relies on secondary data from government databases, academic literature, and existing case studies, and aims to describe long-run structural change in the informal sector rather than to isolate short-term macroeconomic fluctuations or to establish causal effects.

LITERATURE REVIEW

Compliance costs

Vishnuhadevi and Hima Bindu (2022), in a study of GST compliance costs for small businesses in Tamil Nadu, find a sharply regressive pattern: the smallest firms (annual turnover below ₹40 lakh) bear compliance costs equal to roughly 1.45% of turnover, compared to about 0.02% for the largest firms — a more than 70-fold difference in relative burden. Ghosh (2022), surveying MSMEs on their experience of the GST regime, similarly finds that compliance costs were cited as a major constraint by 82% of respondents, with unfamiliar bookkeeping and invoice-matching requirements weighing especially heavily on micro-enterprises; the same survey found that 89% of respondents reported reduced turnover and roughly half had cut staff since GST's introduction.

Working-capital pressure

Working-capital concerns remain prominent even years after implementation. Deloitte India's GST@9 survey of over 1,000 senior executives finds that a majority of MSMEs want faster processing of input tax credit (ITC) refunds and simpler rules for claiming credit, with strong support for automatic interest payments on delayed refunds — evidence that ITC delays continue to tie up small firms' cash. A 2026 Business Standard analysis of the ITC system describes how it has shifted from a 'trust-based' to a 'verification-based' model, where a buyer's credit depends on every supplier further up the chain correctly filing and paying tax; when any link fails, the buyer's credit is blocked, creating working-capital strain that is felt most by firms with long or informal supply chains.

Formalisation and firm size

Patnaik's analysis of GST's design (summarised in Ideas for India) argues that GST created a self-reinforcing 'formalisation cascade': because large, formal firms need supplier invoices to claim their own input tax credit, they place pressure on suppliers to register and document sales, and this pressure then propagates further up the supply chain. Using data on over 12,000 firms from 2013–2022, the analysis finds that firms more exposed to this mechanism increased their documented purchases and reduced tax paid, with the effect growing over five years, and the share of GST collections coming from India's very largest firms falling as smaller firms formalised. However, Nagaraj and Kapoor (2022) caution that registering on a digital platform is not the same as genuine formalisation: they show that although enrolment in various government digital schemes rose sharply after 2016, only about a tenth of the workforce had access to even one social security benefit as of 2018-19, and informal employment's share of the workforce continued to rise between 2017-18 and 2019-20 despite the registration drive.

Rural and micro-enterprises

Yadav and Bari's (2025) study of micro-enterprises finds that GST's effects vary sharply between urban and semi-rural areas: businesses in cities adapted more easily, while enterprises in less-connected districts were held back by limited digital connectivity and a shortage of tax professionals or GST facilitation centres (Suvidha Kendras). Refund delays were reported to be especially common for micro units in remote regions and for exporters, and mismatches between a firm's own filings and its suppliers' returns often caused input tax credit to be delayed or denied — a problem that compounds for rural firms with less bargaining power over larger customers who now require GST-compliant invoices as a condition of doing business.

Literature gap

Most of the existing literature above examines specific channels, such as compliance costs, working capital, or formalisation, in isolation, and does not connect these informal-sector effects to economy-wide trends in indirect tax revenue, GDP, and inflation over the same period. This paper takes the informal-sector literature as its main focus and adds a descriptive, economy-wide backdrop for context, rather than treating the macro trends as separate objectives in their own right.

OBJECTIVES

Primary objective

- To examine how GST has affected small businesses and the informal sector in India, with particular attention to compliance costs, working-capital pressure, and firm-size and formalisation decisions.

Background objectives (used only to provide macroeconomic context, not as independent causal claims)

- Trends in indirect tax revenue
- Trends in GDP
- Trends in inflation (CPI)

Secondary objective

- To summarise commonly cited shortcomings of GST that are particularly relevant to small businesses.

METHODOLOGY

This study is based on secondary research and offers a qualitative, descriptive analysis rather than a statistical or causal one. Four data series are used, and it is important to be precise about what each one actually measures:

1. Indirect tax revenue (Figure 1). Annual nominal indirect tax collections of the central government, in Rs crore, for 2011-12 to 2024-25, from the RBI Handbook of Statistics on the Indian Economy [author to confirm exact table/series reference]. These figures are nominal and have not been adjusted for inflation or for the overall size of the economy, so part of the increase shown reflects general price and GDP growth rather than a change specific to GST.
2. GDP (Figure 2). This paper uses an index of real GDP (base year = 100), not the year-on-year GDP growth rate [author to confirm exact table/series reference]. Because the series is an index rather than a percentage change, a rising or falling line shows the level of output relative to the base year, not the pace of growth - a flat index near 100 does not, by itself, mean the growth rate was zero.
3. CPI/inflation (Figure 3). This paper uses the CPI index level (base year = 100), not the annual inflation rate [author to confirm exact table/series reference]. An upward-sloping index shows that prices kept rising, but this paper does not calculate the year-on-year percentage change in the index, so it does not make quantitative claims about how much the inflation rate itself changed.
4. Informal-sector enterprises and employment (Figure 4). The number of unincorporated non-agricultural enterprises and the number of workers they employ, in crore, for 2015-16 and 2022-23, from MoSPI's Annual Survey of Unincorporated Sector Enterprises (ASUSE).

Because GST's introduction in 2017 coincided with two other major shocks to the Indian economy - the 2016 demonetisation and the 2020-21 COVID-19 pandemic - none of the trends described in this paper can be cleanly attributed to GST alone. Where the Results and Discussion sections describe a pattern as 'consistent with' or 'in the direction of' a GST effect, this reflects a descriptive association drawn from the timing of the data, not a tested causal claim. Due to the informal sector operating largely outside formal regulatory frameworks, data availability is limited, and this study relies on existing published sources, which may not fully capture regional or sector-specific variation.

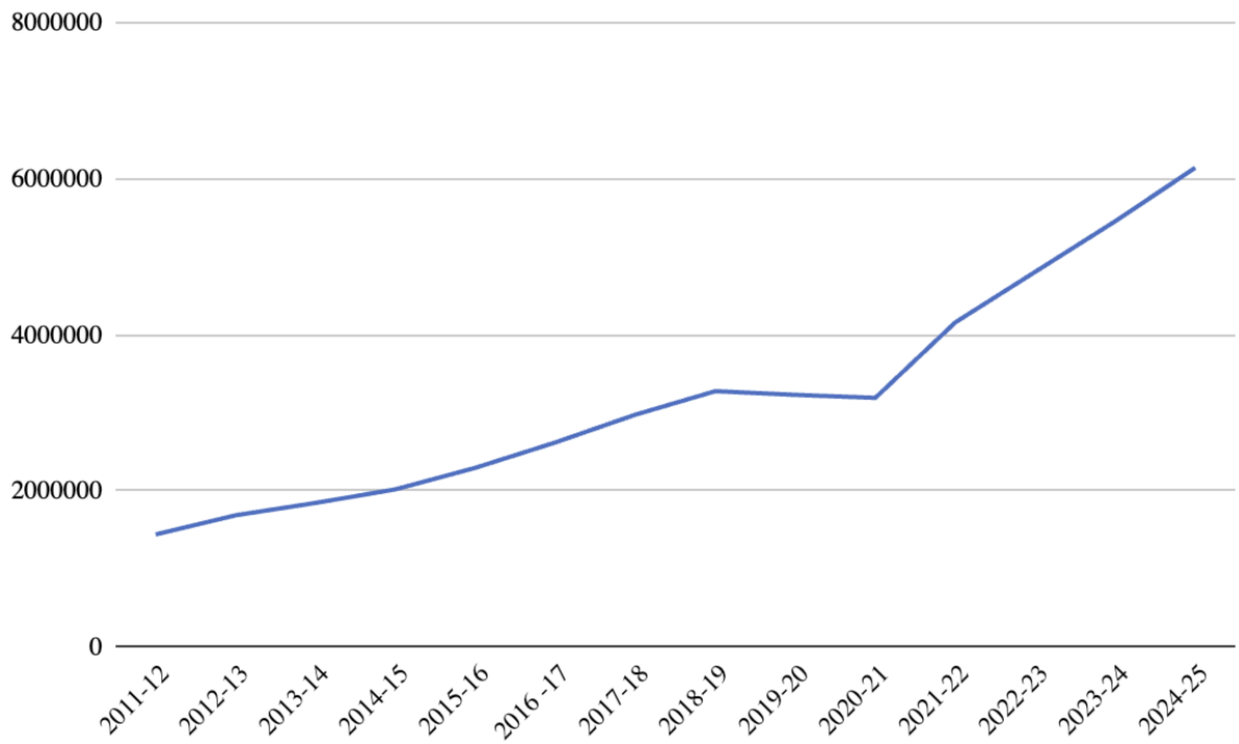
RESULTS AND ANALYSIS

The sections below present each data series in turn. Consistent with the methodology above, the discussion is descriptive: where a pattern lines up with the timing of GST's introduction, this is reported as an association, not a demonstrated causal effect, because the same period also includes demonetisation and the COVID-19 pandemic.

Objective 1 - Indirect tax revenue

Figure 1 shows nominal indirect tax collections rising continuously from 2011-12 onward, with a steeper increase after 2016-17 - around when GST was introduced - and again after 2021-22. Because these are nominal figures that have not been adjusted for inflation or GDP growth, part of this increase reflects the broader growth of the economy and rising prices, not only a change in tax policy or compliance. The pattern is consistent with GST supporting higher indirect tax collection, for example through the digitisation of filing and a wider tax base, but it is equally consistent with the kind of nominal growth that would likely have occurred regardless of GST. This paper does not attempt to separate these two explanations.

Figure 1: Trend in Annual Indirect Tax Revenue In Comparison to the Year (2011–12 to 2024–25)

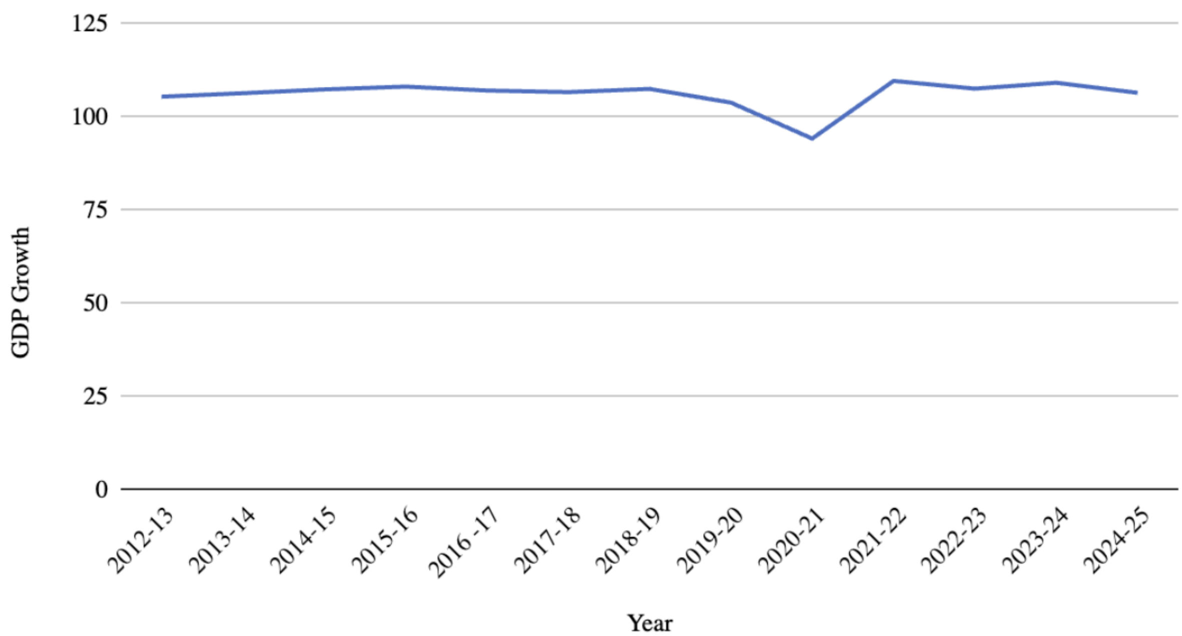


Sources- Author's own estimation using data from RBI Statistical Handbook 2024-25 Table 103

Objective 2 - GDP

Figure 2 plots a real GDP index (2011-12 base = 100) rather than the annual GDP growth rate. Read this way, the index stays close to 100-110 for most of the period, falls sharply in 2020-21 - consistent with the well-documented COVID-19 contraction, including a reported 24.4% drop in output during Q2 (April-June) FY2020-21 (Choudhary, 2020) - and recovers in the years after. There is no clear break in the index around 2016-17, when GST was introduced, which suggests GST did not produce an obvious, large shift in the level of real output over this period. However, because this paper uses an index rather than a computed growth rate, it cannot make a precise quantitative statement about how much, if at all, GST affected the GDP growth rate - this should be read as a description of the index's shape, not an estimate of GST's effect on growth.

Figure 2: Trend for GDP Growth To The Year (2012-13 to 2024-25)

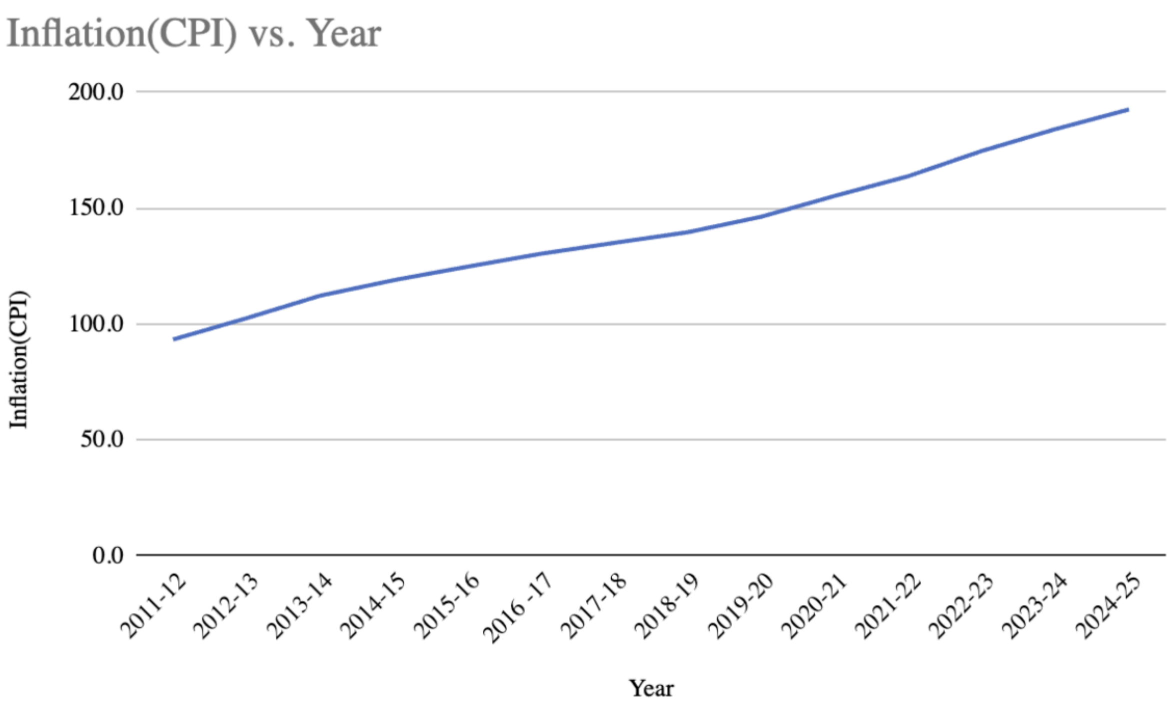


Sources- Author's own estimation using data from RBI Statistical Handbook 2024-25
Table 1

Objective 3 - Inflation (CPI)

Figure 3 plots the CPI index level (base = 100), not the annual inflation rate. The index rises steadily across the whole period, from roughly 95 in 2011-12 to around 193 by 2024-25, with no obvious change in slope around 2016-17. Because a rising index level is exactly what would be expected even under a constant, unchanged inflation rate, this figure on its own cannot show whether inflation accelerated, slowed, or stayed about the same after GST - that would require calculating the year-on-year percentage change in the index, which this paper does not do. An earlier draft of this paper described GST as ‘likely fuelling an increase in inflation’; on reflection, the evidence presented here does not support that specific claim, and it has been removed.

Figure 3: Increase in Inflation (CPI) from 2011-12 to 2024-25



Sources: Author's own estimation using data from RBI Statistical Handbook 2024-25 Table 242

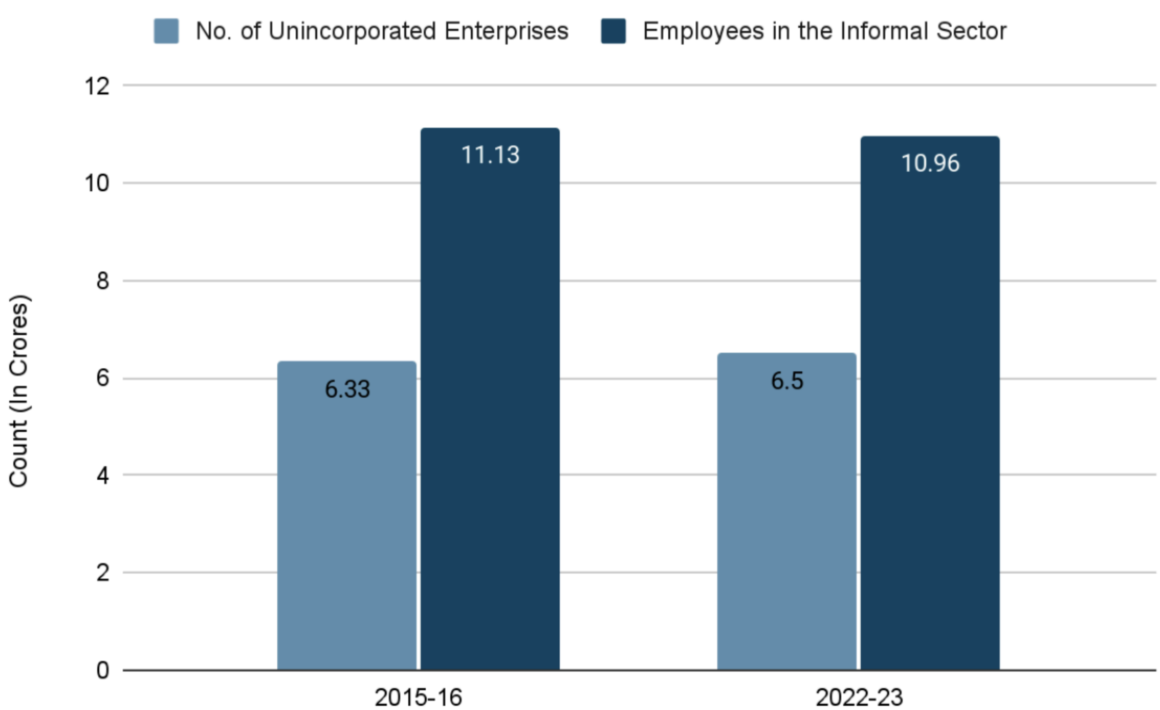
Objective 4 - Informal-sector enterprises and employment

Figure 4 compares the number of unincorporated enterprises and the number of people they employ in the informal sector, in crore, between 2015-16 and 2022-23, using MoSPI's ASUSE survey. The number of unincorporated enterprises rose slightly, from 6.33 crore to 6.5 crore, while the number of employees in the informal sector fell slightly, from 11.13 crore to 10.96 crore.

Together, this means the average number of workers per enterprise fell - enterprises became somewhat more numerous but, on average, smaller. This pattern is consistent with the idea that GST's compliance requirements (return filing, input tax credit documentation, and the associated accounting burden) have pushed some businesses toward smaller workforces, sole proprietorships, or unpaid family labour. However, the ASUSE data alone does not identify GST as the cause, and it does not rule out other explanations, such as businesses splitting operations to stay below the GST registration threshold, or unrelated structural change in the labour market.

Figure 4: Trend in number of unincorporated enterprises and employment in India's informal sector (2015–16 to 2022–23)

Source: MoSPI, ASUSE (2015–16; 2022–23)



Objective 5 - Shortcomings of GST relevant to small businesses

GST has some limitations that are particularly relevant to this paper's focus on small businesses. First, GST is not a single, uniform amount paid equally by everyone: it is charged at different rates depending on the good or service, since India applies multiple GST slabs, so no one pays a fixed rupee amount regardless of what they buy. What is true is that, because GST is a tax on consumption rather than on income, its burden as a share of income tends to fall more heavily on lower-income households, who spend a larger proportion of what they earn. This is a feature of consumption taxes in general rather than something specific to GST's design, and it also depends on what a household actually buys, since many essential goods are taxed at lower rates or exempted.

Second, compliance costs are largely fixed rather than scaling with turnover, so they take up a proportionally larger share of revenue for small firms than for large ones. Third, the timing rules around GST - tax becomes payable when an invoice is raised, not when payment is actually received - can create a working-capital gap for firms waiting on customer payments, and this matters more for small businesses with limited cash reserves than for larger firms with more financial cushion.

DISCUSSION

The changes observed in the informal sector before and after GST's introduction suggest a structural shift in how unincorporated enterprises operate. Before GST, employee counts in the informal sector tended to rise together with the number of unincorporated firms. Increased compliance requirements, such as regular return filing and input tax credit documentation, may have discouraged informal firms from employing larger workforces, pushing some toward sole proprietorships and family-run operations to reduce wage and compliance costs - though, as noted above, this remains an association rather than a demonstrated causal effect.

The rise in nominal indirect tax revenue after 2016-17 is consistent with GST improving tax transparency, widening the formal tax base, and reducing evasion, which are commonly cited benefits of the reform. However, because the revenue figures are nominal and have not been adjusted for inflation or GDP growth, and because this paper has not isolated GST's contribution from ordinary economic growth, this should be read as a plausible interpretation rather than a demonstrated result.

GDP, read as an index rather than a growth rate, shows no obvious break around GST's introduction, aside from the COVID-19-related dip in 2020-21. The CPI index continued on a rising path that was already underway well before 2017. As discussed above, neither figure, on its own, can show whether GST changed the GDP growth rate or the inflation rate, and this paper does not claim otherwise.

The rise in unincorporated enterprises alongside improved digital record-keeping is consistent with GST making it somewhat easier to start an informal enterprise. However, as discussed under Objective 4, this is not the same as showing that GST caused higher formalisation or a genuine rise in entrepreneurship overall - an increase in unincorporated enterprises could equally reflect existing informal activity reorganising into smaller units.

Throughout this discussion, it is important to keep in mind that the data used here do not isolate GST from other major shocks over the same period, particularly the 2016 demonetisation and the COVID-19 pandemic. The observed trends are consistent with a GST-related effect in several places, but no conclusive causation can be established from descriptive data of this kind.

CONCLUSION

This paper examined the impact of GST on India's informal sector, using secondary data from government reports, academic literature, and policy studies. Existing literature focuses largely on the formal sector and on consumers, leaving a gap in the detailed study of informal enterprises; this paper aimed to address that gap, while treating economy-wide trends in tax revenue, GDP, and inflation as background context rather than as separate claims about GST's effects.

The findings point to a mixed picture for the informal sector. On one hand, GST appears to have contributed to improved tax transparency and digital record-keeping, and is associated with a modest rise in the number of unincorporated firms. On the other hand, higher compliance costs, more frequent filing, and delays in input tax credit refunds - as reported across the literature reviewed - appear to have placed real administrative and financial burdens on informal-sector businesses, and are associated with a modest decline in informal-sector employment as firms shift toward smaller workforces, unpaid family labour, or sole proprietorship.

Overall, the evidence suggests that GST's effects on the informal sector have not been uniformly positive or negative, and that a rise in unincorporated enterprises should not be read as straightforward formalisation. Because of data limitations and the overlap with demonetisation and COVID-19, this paper does not draw definitive causal conclusions, and presents its findings as descriptive associations that future research, ideally with firm-level or longitudinal data, could test more rigorously.

The GST 2.0 reforms announced in September 2025 fall entirely outside the 2011-12 to 2024-25 data window used in this paper, so none of the analysis above reflects their effects. This paper does not draw any conclusions about GST 2.0, and any future assessment of it would need new, post-reform data.

AI ACKNOWLEDGEMENTS

During the preparation of this work, I, Hriday Sharma, used Google Gemini to help discover literature for the Literature Review section and to research the history of GST for the Introduction. An earlier draft of this section relied on AI-suggested citations that could not be independently verified and have since been replaced with sources that were checked directly against their original publications (see the Literature Review and References for the current, verified list). The interpretation, analysis, and use of this material was carried out by me, the author. After using AI tools, I reviewed and edited the content as needed and take full responsibility for the content of this publication.

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