Original Article

Formalising the Informal through GST: Evidence from a Survey of MSMEs

Review of Development and Change
27(2) 150–169, 2022

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in.sagepub.com/journals-permissions-india
DOI:10.1177/09722661221130138
journals.sagepub.com/home/rdc
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Sangeeta Ghosh[1]

Abstract

In this study, the processes and channels through which an indirect tax reform has impacted micro, small and medium enterprises in India are identified using a field survey of small businesses. The Goods and Services Tax introduced in 2017 in India has been a significant departure from the past to impact businesses and business practices in a way that introduces formal practices into the everydayness of small businesses. This study shows that established informal mechanisms have been disturbed, which has led to coping mechanisms that have borne adverse outcomes for small businesses and workers involved in them. The benefits from such a move have been rather limited for small businesses. This study advocates that the quest to transition from an informal to a formal economy is one where many small steps must be first identified, and necessary handholding and training for the vulnerable units must be provided for inclusive development.

Keywords

Informal sector, MSMEs, informal labour, GST, indirect tax reform, formalisation

Introduction

The importance of the informal sector in the functioning of the Indian economy is well recognised, in terms of not only its contribution to GDP and exports, but also employment and livelihood generation. However, the benefits of formalisation are immense. From an employment viewpoint, 'formal' is associated with better job quality and access to social security. From an enterprise viewpoint, formalisation is associated with bureaucratic and legal recognition, where registration into a formal network can help the state perform its bureaucratic

[1] Institute for Studies in Industrial Development (ISID), New Delhi, India

Corresponding author:
Sangeeta Ghosh, Institute for Studies in Industrial Development (ISID), 4 Institutional Area, Vasant Kunj, Phase II, New Delhi 110070, India.
E-mail: sangeetaghosh1982@gmail.com

functions and reach out to enterprises for various facilitation and training programmes. Without a registered base of enterprises, it is difficult for the state machinery to reach out for training and facilitating programmes related to credit access, market access or any outreach programmes. However, registration into one or the other act has not been completely new to the informal sector in India, but such registrations do not mean formalisation (Mehrotra & Giri, 2019). Registrations are at best the first steps in the quest to formalise.

Affirming that 'the transition from the informal to the formal economy is essential to achieve inclusive development and to realise decent work for all', the 104th International Labour Conference in June 2015 urged its members to 'take urgent and appropriate measures to enable the transition of workers and economic units from the informal to the formal economy, while ensuring the preservation and improvement of existing livelihoods during the transition' (International Labour Organization [ILO], 2015). The ILO adopted Recommendation 204: Transition from the Informal to the Formal Economy, which provided guidelines to members to do the following:

> (a) facilitate the transition of workers and economic units from the informal to the formal economy, while respecting workers' fundamental rights and ensuring opportunities for income security, livelihoods and entrepreneurship; (b) promote the creation, preservation and sustainability of enterprises and decent jobs in the formal economy…; and (c) prevent the informalisation of formal economy jobs. (ILO, 2015)

With respect to formalising informal enterprises, it guides members to undertake business entry reforms by reducing registration costs and length of procedure, improve access to services through ICT, reduce compliance costs through simplified tax and payment regimes, promote access to public procurement with quotas for smaller units, provide training and advice for participation in public tenders, improve access to financial services and entrepreneurship training, and improve coverage of social security (ILO, 2015). Hence, the transition from the informal to the formal economy is a gradual process with a series of serious interventions for inclusive development where handholding and training are required for such a transition.

In India, the recent focus on formalising the economy has been through certain measures such as (a) demonetisation in 2016 that increased the number of digital financial transactions at the point of sale; (b) the accompanying Amnesty scheme that caused the registration of many workers into the Employee Provident Fund Organisation (EPFO; see Unni, 2018, for a detailed discussion); and (c) the implementation of the Goods and Services Tax (GST) in July 2017 that brought a vast number of informal enterprises into the tax net through an overhauling change in the taxation regime. Unni (2018) argues that the quest to formalise the informal economy by bringing them into the tax net has done so through the lens of capital, without passing on the benefits of formalisation to the workers. Roy and Khan (2021) argue that the digitisation of the taxation systems can be a tool to assist inclusion but may also inadvertently lead to adverse outcomes for the poor in developing countries where many firms in the informal sector have low capabilities. They warn that adverse outcomes for welfare and inclusion can follow from 'premature formalisation' and advise for a more cautious and inclusive path to formalisation to protect vulnerable groups.

Many newspaper reports (Rajagopalan, 2018; Rajshekhar, 2017; Srinivasan & Shankar, 2018; Srivastava & Chaudhary, 2017; to name a few), as well as sector reports by industry associations, have discussed and documented the hardships faced by informal units due to the implementation of the GST. Right after the implementation of the GST, micro, small and medium enterprises (MSMEs) raised concerns regarding the cost of compliance with it, which affected their viability (Tyagi et al., 2019). Larger firms had well-functioning and automated finance departments in place, whereas smaller businesses had to deal with new financial and bookkeeping systems. There is evidence of heterogeneous effects across firm types due to an enhanced enforcement of tax systems in other developing countries (Joshi et al., 2014, as quoted in Roy & Khan 2021). Roy and Khan (2021) have systematically brought out and highlighted the need for an analysis of the Indian experience with respect to the GST network, as similar platforms are being considered for other developing countries. 'The dominant narrative about the economic and political benefits of enforcing formal tax rules has suppressed the growing evidence that the formalisation of MSME taxation may be premature and may widen their social gap with firms of higher capabilities' (Roy & Khan, 2021, p. 12).

Responding to these hardships, the GST Council have revised the GST rules over time. The frequent and multiple revisions to the rules show that the GST at the time of implementation was far from an envisaged simplification of the indirect tax regime. In this discourse, however, there is a dearth of systematic research that has analysed the impact of the GST on small businesses. This article tries to fill that gap. First, it identifies how the GST is a departure from the past to impact small businesses. Though a value-added tax system, what is it about the GST that makes it different from the past regime? This article develops a framework to look at these departures and understand how they impact the choices for smaller businesses. Second, this article highlights the processes and channels through which the new tax regime has impacted the structure of doing business for a number of small businesses. It does so by drawing evidence from field surveys. The methodology for the field survey is discussed in the third section. This article uses an innovative way of tracing supply chains and businesses that did interrelated and interdependent business when possible. This helps understand the impact their businesses had on one another and shed light on the ecosystem of business relations between enterprises and how a tax regime change impacted the ecosystem. This article argues that informal norms of doing business that were the very fabric of business relations between small businesses—from credit arrangements to buyer–supplier linkages, and movement of unsold stock of goods—has been put under strain. With the induced formalisation and digitalisation of the tax system, adverse outcomes have been felt disproportionately by smaller businesses. Third, this article points to certain coping strategies of the businesses, playing their way through labour market adjustments that impact the workers in this sector. It advocates that the quest to transition from an informal to a formal economy is one where many small steps must be first identified, and necessary handholding for the vulnerable units must be provided to ensure that the outcomes for small businesses are not adverse.

A Departure from the Past: Features of the GST that Raise Challenges for Smaller Businesses

The GST subsumes a number of central and state taxes, and it aims to simplify the indirect tax structure. Essentially a modification to its predecessors modified value added tax (MODVAT, introduced in 1986) and value added tax (VAT, introduced in 2005), it differs from them in the following significant ways. Being a destination-based ad valorem tax that covers both goods and services, it has provisions for input tax credit (ITC) across the entire value chain. Based on a dual collection principle by the centre and the state, it removes hurdles to claiming ITC due to separate jurisdictions that existed in the pre-GST regime. It thus allows for the seamless flow of ITC and minimises cascading of taxes. Following the principle of reverse charge mechanism (RCM)—whereby the recipient of the goods or services pays the tax and not the manufacturer—and a system of invoice matching, it envisages a self-policing mechanism to control tax evasion. This combination of features essentially means that any entity in a business-to-business (B2B) transaction while dealing with an enterprise that is registered with the GST will face an implicit requirement to register themselves under the GST due to the RCM clause so that claiming ITC is possible for the buyer enterprise.

Additionally, the GST functions based on the GST network that records online filing of returns and payment of taxes dependent on software, and thus is far more IT dependent in its very functioning than ever before. This makes compliance with the new tax regime particularly challenging for small enterprises that do not have the human resource as well as the technological know-how to comply with the GST.

These features of the GST impact the market share, buyer–supplier linkages and subcontracting arrangements of businesses in the following ways. Larger firms would not be able to claim ITC for the products or services they buy from unregistered dealers, and this would make them unwilling to enter subcontracting arrangements or other contracts with unregistered dealers. This would limit market access for unregistered dealers. However, it may force small businesses to register under the GST so as to not lose business and market share. This would particularly be true for small firms in B2B transactions. Thus, the fallout for smaller businesses would be to either lose business or bear the consequences of higher compliance costs registering under the GST, even though the GST Council and rules allow for revised upper limits of exemptions for small businesses. This additional cost of compliance would impact the profit margins of smaller firms. It may also give rise to a practice where the smaller supplier firm may have to cut down on its own profit markup in order to nullify the reverse charge for the buyer firm.

Thus, even if a firm is below the specified threshold to mandatorily register under the GST, in reality, the choice is limited. Businesses that could opt to register under the optional composition scheme and pay an annual tax on their total turnover are compelled to register under the GST, particularly when they deal in B2B transactions. The GST Council Minutes point to the low registrations under the composition scheme, with only 22% of the eligible composition scheme businesses registered under the scheme. There are other reasons for the low sign-up for the composition scheme as well: the low initial threshold for the composition scheme; withdrawal of the RCM clause after a year when businesses had already registered; and fear of harassment (Ghosh, 2020).

Also, since B2B businesses below the threshold for GST registration face the same set of issues as composition scheme businesses, there is a tendency to register under the GST for them as well. The revenue secretary is quoted to have said that 'even though currently the exemption limit is ₹20 lakh, but still there are about 10.93 lakh taxpayers who are below ₹20 lakh but are paying taxes' (Press Trust of India, 2019). That itself would mean that 9% of the total GST registrations are from enterprises that are below the threshold of ₹20 lakh (Ghosh, 2020). This shows the overwhelming tendency of businesses to register under the GST, even when eligible for exemptions, notwithstanding the compliance costs.

Thus, the GST institutionalises a coercive tendency to bring firms that could well be outside its ambit into the tax regime. This phenomenon presents an interesting sidestep to the idea that 'threshold creates an obvious distinction between those who end up above the threshold and those who end up below' (Kanbur & Keen, 2014), because in spite of the presence of a threshold to register under the GST, other intrinsic features of this tax regime override thresholds as the defining point to distinguish between those who file taxes and those who do not. It applies coercive pressure to register under the GST even on firms below the threshold. This was not the case previously, when firms only above a certain turnover threshold, for example, had to pay central excise duty. It is the intrinsic structural features of the GST itself that create these complexities.

The extent to which the unorganised sector has come under the tax net will be clear from the next National Statistical Office (NSO) rounds. The NSSO 73rd round that undertook surveys of unincorporated non-agricultural enterprises bears testimony to the low number of enterprises that were registered under the VAT or sales tax in 2015–2016, a year before the roll-out of the GST. Out of the 633.93 lakh estimated enterprises, only 2.383 million enterprises (3.76%) were reported to be registered under the VAT/sales tax. This of course was much higher at 16% for establishment enterprises (those who hired at least one worker). Figure 1 shows the percentage of all enterprises as well as establishment enterprises registered under the VAT/sales tax by industrial sectors arranged by their employment share in total employment. The sectors captured in Figure 1 account for 95% of employment and enterprises. It can be observed that the manufacture of food products, tobacco, textiles, wearing apparel, leather, wood, furniture and other manufacturing, and, among the service sector repairing activities and food and beverages service activity—which make for the bulk of the unorganised sector—had low VAT registrations ranging between 0% and 1.5% for all enterprises and around 5% for establishment enterprises. Retail trade and wholesale and retail trade had higher registrations under the VAT/sales tax.

A large-sample survey like the NSSO is a rich source of data of unincorporated enterprises. It can be hoped that in the next rounds of NSSO, a fair amount of

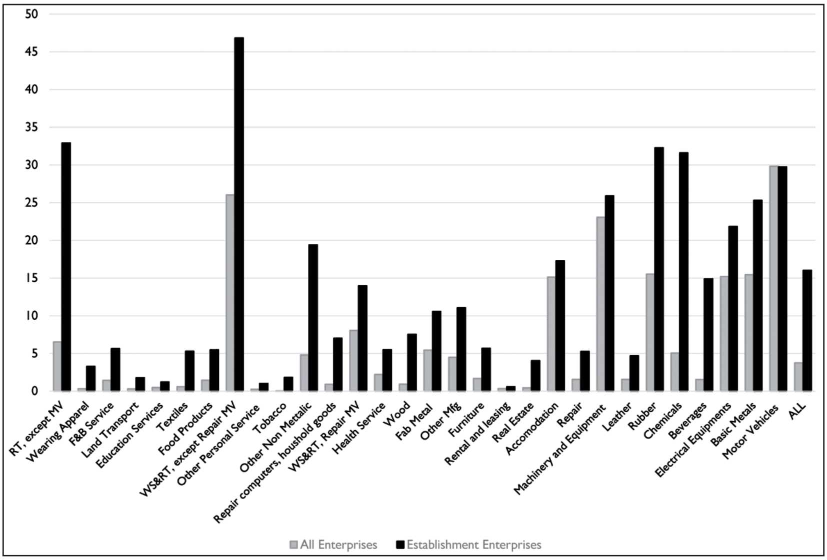

Figure 1. Percentage of Enterprises Registered Under VAT/Sales Tax (2015–2016).

Source: NSSO 73rd Round, Unit Level Records, 2015–2016.

information will be available on the adoption of the GST by small businesses. Given the non-availability of macro-data, we had to rely on the primary survey to study the impact of this indirect tax regime change on the informal sector.

Methodology and Description of the Sample

We conducted a survey of 157 MSMEs in Delhi (50), Mumbai (57) and Surat (50) from December 2018 to March 2019, and we interviewed owners, managers, accountants and workers as per the availability of the resource persons using structured questionnaires as well as unstructured interviews. Since an official listing of the MSMEs is not readily available, we could not devise a sample framework. We used the snowballing technique to identify enterprises in a supply chain framework. Once an enterprise resource person was willing to be interviewed, we would ask them to recommend others to interview. In this way, we developed a sample based on the network of the initial respondents. To avoid biases arising from the recommendation of a similar nature as the initial enterprise, we purposely selected the first units of the survey. This helped to ensure diversity in product lines, plant size, type of business, activity type and so on. We developed the survey methodology using Pickbourne (2018) and Pickbourne and Ramnarain's (2018) combination of qualitative and quantitative survey techniques.

Whenever possible, we tried to follow up on a supply chain. For example, in Surat, our sample included grey cloth manufacturers who spun grey cloth from yarn; traders who supplied grey cloth to the dyeing units for job work; manufacturers of dye intermediaries; embroidery units who performed job work on dyed cloth given to them by the trader; and, finally, wholesalers and retailers in the local textiles markets in Surat. Similarly, we followed the hosiery supply chain, where we surveyed latex thread manufacturers, elastic manufacturers, hosiery manufacturers and retailers. For the leather supply chain too, we surveyed traders of leather hides, traders of metal parts used in leather products, leather product manufacturers and traders. Tracing these product lines and businesses that did inter-related and interdependent business when possible was important so as to understand the impact their businesses had on one another and to shed light on the ecosystem of business relations between small enterprises and how a tax regime change impacted this ecosystem.

Of the 157 enterprises surveyed, 60.51% were micro units and 39.5% were small and medium enterprises (SMEs). The list of product groups surveyed and their distribution by micro or SME size classes are presented in Table 1. It was important to survey a range of product lines to identify and understand the issues faced by them due to the introduction of the indirect tax reform and to underline the similarities and differences faced by different lines of manufacturing, job work and trade.

Two-thirds of the enterprises surveyed were into manufacturing activities alone, while 2.6% were into manufacturing and trade; 19% were trading enterprises, and 12% were into job work (Table 2). The MSMEs surveyed were all located on premises outside the household. All units used power/electricity. More than three-fourths of the enterprises (76.4%) were into B2B transactions, 7.6% were into business-to-consumer (B2C) transactions, whereas 16% were into both

Table 1. Sample Units by Size and Products.

Products	No. of Units Surveyed (N)	Micro (%)	SME (%)
Chemical	23	39.13	60.87
Elastics	17	100	0
Grey Cloth	15	0	100
Hardboard	12	100	0
Hosiery manufacturing	5	100	0
Job work in textile	13	23.08	76.92
Latex thread	6	0	100
Leather	14	50	50
Machinery	12	66.67	33.33
Metal parts	25	76	24
Textile retail	15	100	0
Total	157	60.51	39.49

Source: Field survey,
Notes: The definition for MSMEs is as of the MSME Development Act, 2006. As of May 2020, the definition has changed.
For the manufacturing sector (investment in plant and machinery), micro: < ₹25 lakh; small: > ₹25 lakh but < ₹5 crore; medium: > ₹5 crore but < ₹10 crore.
For the service sector (investment in equipment), micro: ≤ ₹10 lakh; small: > ₹10 lakh but < ₹2 crore; medium: > ₹2 crore but ≤ ₹5 crores.

Table 2. Sample Characteristics by Type of Enterprise.

	Micro (N = 95)	SME (N = 62)	Total (N = 157)
Sector			
Manufacturing	65.2	67.7	66.2
Manufacturing and trade	0	6.5	2.6
Trade	31.6	0	19.1
Job work	3.2	25.8	12.1
Type of business			
B2B	71.6	83.9	76.4
B2C	12.6	0	7.6
Both	15.8	16.1	16
Type of premise			
Own	92.6	91.9	92.4
Leased	7.4	8.1	7.6
Years of operation			
3–10 Years	9.5	16.1	12.1
11–25 Years	60	61.3	60.5
> 25 Years	30.5	22.6	27.4
Bookkeeping			
Yes	73.7	98.4	83.4
Digital bookkeeping	6.3	56.5	26.1
Type of transaction			
Cash Only	75.8	24.2	55.4
Cash + Bank mode	17.9	74.2	40.1
Cash + Bank + Others	6.3	1.6	4.5

Source: Field survey.

B2B and B2C transactions. Most of these enterprises (92.36%) owned the premise out of which they operated, whereas 7.64% had leased units. Most of the businesses (88%) had existed for more than 10 years.

Whereas 83% of the enterprises always maintained a book of accounts, one-fourth of them did so digitally before the GST was implemented. This proportion was much lower among micro units (6.3%) and much higher among SMEs (56.5%). Three-fourths of the micro units and one-fourth of the SMEs were into cash transactions alone. These characteristics are summarised in Table 2.

Limitations of the Study

The limitations of the study need to be kept in mind. This study is based on a small sample of the MSME sector, which itself is large and variegated in its business practices. The results are largely qualitative in nature. However, the strength of this study lies in its exploration of the effects of a huge tax reform such as the GST and in understanding the processes and channels through which it has impacted small businesses. It also helps us explore dimensions of informality and its interactions with the taxation system.

MSMEs under GST

A large proportion (93%) of the businesses surveyed took registrations under the GST irrespective of their annual turnover. The distribution by average annual turnover of enterprises is shown in Table 3. Category 1 enterprises are exempted under the GST with a turnover of less than ₹2 million (6.4% of the total surveyed enterprises were in this category); 51% of the enterprises were in Category 2, and they could opt for the composition scheme; 43% were in Category 3, and they were to mandatorily register under the GST. These were the thresholds at the time of the survey and have been revised subsequently. As shown in Table 3, many of the enterprises in Categories 1 and 2 took GST registrations; 70% of the enterprises below the threshold of ₹2 million took GST registrations; and of the units eligible for the composition scheme in Category 2, only 8.75% actually registered under the scheme, whereas 90% had registered under the GST.

It would be important to state that our sample shows such high percentages in both these two categories as 76% of the enterprises surveyed were in B2B transactions, whereas 16% were in both B2B and B2C transactions. As explained earlier, enterprises in B2B transactions face implicit pressure to register under the GST due to ITC, RCM and supply-chain-related pressures. The Minutes of the 32nd GST Council (2019) reveal that around 22% of those eligible for the composition scheme had opted for the scheme, whereas the rest chose to register under the GST. Thus, we see that irrespective of the turnover thresholds, enterprises were registering under the GST.

Table 3. Registration into the GST by Turnover Distribution.*

Turnover Distribution	Yes	Composition Scheme	No	Total	
Category 1: < ₹2 million	70	0	30	100	(6.37)
Category 2: > ₹2 million & < ₹10 million	90	8.75	1.25	100	(50.95)
Category 3: > ₹10 million	100	0	0	100	(42.68)
Total	92.99	4.46	2.55	100	(100)

Source: Field survey.
Note: Figures in parentheses in the last column show the distribution of enterprises surveyed by turnover in total.
*Verification of annual records of the units was not possible. Many units did not keep a book of accounts. This is also evident from NSSO rounds that report only 12% of the enterprises maintain a book of account; data from the book of accounts are collected for a negligible percentage of enterprises (0.13%). There was reluctance on part of the entrepreneurs/accountants to give details about turnover. In most cases, providing them with the range (as used in this analysis: less than ₹2 million, between ₹2 million and ₹10 million, and more than ₹10 million) was useful in data collection.

Table 4 shows the percentage of enterprises surveyed that are filing or not filing taxes in the pre- and post-GST regimes. Around 55% of the enterprises surveyed were filing the VAT, 2% were filing service taxes, 4% were filing both the VAT and service taxes, and 39% were not filing taxes in the pre-GST regime. Although all the firms that were filing the VAT, service tax or both had migrated to the GST regime, 82% of the firms that were not filing any taxes were now registered under the GST, whereas 11% were under the composition scheme. Only 6.45% of the enterprises continued to not file taxes.

However, the impact of registering under the GST was felt differently by different lines of businesses.

Of the enterprises surveyed, more than 50% reported a reduction in turnover by 10%–30%, while 36% reported their turnover to have reduced by more than 30% after the implementation of the GST (Table 5). Micro-enterprises reported facing a greater reduction in their turnover than SMEs. The reasons for this decline are discussed in this section.

The GST was introduced in India eight months after demonetisation. The rollback of 86% of the currency from the economy had brought about a massive shock, in terms of both demand and supply chain transactions, particularly for the informal sector that almost exclusively dealt in cash. Before they could stabilise and take care of their unsold inventories, the GST was introduced. Of the surveyed enterprises, 90% (97% of the micro units and 81% of the SMEs) reported the lack of demand to be the most severe problem faced by them (Table 6). A depression in demand was felt widely, however, even before GST was implemented. The tax

Table 4. Migration from Taxation in the Pre-GST Regime to the GST.

	Yes	No	Composition Scheme	Total	
VAT	100	0	0	100	(54.78)
Service	100	0	0	100	(1.91)
Both	100	0	0	100	(3.82)
Not filing tax	82.26	6.45	11.29	100	(39.49)
Total	92.99	2.55	4.46	100	(100)

Source: Field survey.
Note: Figures in parentheses in the last column show the percentage of those filing taxes or not in the pre-GST regime.

Table 5. Effect on Perceived Monthly Turnover by Enterprise Type (%).

	Reduced 10%–30%	Reduced by >30%	Same	Increased
Micro	57.89	38.95	2.11	1.05
SME	45	32	20.97	1.61
Total	52.87	36.31	9.55	1.27

Source: Field survey.
Note: Pearson $chi^2(3) = 15.6763$; $Pr = 0.001$.

Table 6. Challenges Faced after Implementation of the GST.

	Challenges Faced After Implementation of the GST									
Type of Unit/ Product Lines	Lack of Demand	Higher Taxes	Higher Input Costs Due to Taxes	Blocked Working Capital	Inverted Duty Structure	Greater Delay in Payments	Compliance Costs	Buyer–Supplier Linkages	Restrictions to Movement of Goods	No. of Units Surveyed
Micro units	96.8	54.7	42.1	57.9	12.6	60	85.3	74.7	27.4	95
SMEs	80.6	41.9	46.8	59.7	33.9	21	75.8	25.8	11.3	62
Chemical	87	52.2	26.1	69.6	30.4	34.8	69.6	69.6	0	23
Elastics	100	64.7	100	64.7	64.7	100	100	100	0	17
Grey cloth	100	0	100	100	100	0	100	0	0	15
Hardboard	100	100	0	0	0	0	100	100	0	12
Hosiery	80	0	100	0	0	0	100	100	60	5
Job work in textiles	61.5	0	0	0	0	0	69.2	0	0	13
Latex thread	100	100	100	100	0	100	100	100	0	6
Leather	100	50	100	85.7	0	100	64.3	0	100	14
Machinery	66.7	41.7	0	41.7	0	41.7	66.7	41.7	0	12
Metal	92	100	24	84	0	56	100	80	4	25
Textile and Hosiery retail	100	0	0	40	0	40	40	40	100	15
Total	90.4	49.7	43.9	58.6	21	44.6	81.5	55.4	21	157

Source: Field survey.

reform only exacerbated the problem further in an already weak economy (Babu & Jithen, 2020; Dasgupta, 2020). As per the NSSO 2015–2016 survey too, the biggest problem reported by 39% of the enterprises was the lack of demand.

Other identified reasons that became a challenge for businesses after the roll-out of the GST were as follows: increase in compliance costs and associated paperwork (reported by 81.5% of the surveyed enterprises); blocked working capital due to taxes paid (58.6%); distortions in buyer–supplier chains (55.4%); greater delays in payments (44.6%); facing higher taxes than before (49.7%); higher input costs due to taxes (43.9%); facing inverted tax duty (21%); and restrictions to the flexibility of movement of stock (21%). These factors overlapped and played their roles in various businesses in different ways (summarised in Table 6). These factors need a detailed discussion.

Compliance costs and associated paperwork was the second-most pervasive problem (after lack of demand) facing small businesses under the GST. Four-fifths of the businesses surveyed found compliance to be a challenge. Many, filing taxes for the first time, were unaccustomed to the elaborate and complex bookkeeping. The GST necessitated a familiarity with information and communication technology and software that was beyond the capability of many small businesses. Many took recluse to hiring part-time or full-time chartered accountants to manage their books, even as their profits and incomes dwindled. Space for such bookkeeping and maintaining a computer in a small factory premise was a challenge too. During our survey, we saw some enterprises that could not hire someone for bookkeeping bank on family labour, an educated male child or sibling maybe (pursuing their studies), to help with bookkeeping to adhere to the complex bookkeeping processes. Another coping mechanism was to collectively hire one accountant who took care of the books of similar businesses in one locality. The forced modes of formal bookkeeping and filing of taxes, in which each and every transaction needed to be recorded, was an overarching task for small businesses. Digitalising these transactions meant a massive amount of labour for these enterprises, hitherto unaccustomed to such practices. It restricted their capacity to function, and it was reported to be a major hindrance by 85% of the micro units and 76% of the SMEs among the surveyed.

Paying taxes before the circle of payment was complete would result in blocked working capital for close to 60% of the enterprises. In business relations, payments are often made only after the final sale, in which case a delay in payments of around 45 days is often the informal norm. These transactions are based on trust and long-standing business relations between similar enterprises or even between big and small enterprises. With the GST, where taxes would have to be filed much more frequently (monthly initially), enterprises would have to cut their working capital just to pay taxes. Some enterprises reported taking loans from family and friends to pay taxes on time.

Along with this, the problem of delayed payments was exacerbated in 45% of the enterprises. The delay of payments increased to 75–90 days as related businesses were under duress. This problem was felt much more by micro-units (60%) compared with 21% of the SMEs surveyed.

An inverted duty structure was present for certain product groups. The power loom sector manufacturing grey cloth in Surat, for example, faced an inverted tax duty structure. Yarn, a primary input, was taxed at 18% tax (12% after the GST Council revisions), whereas the final product, grey cloth, was taxed at 5%. This resulted in blocked credit for the enterprises in their GST ledger. This issue of inverted tax duty was raised in the GST Council meetings. The GST Council decided to disburse the blocked credit to these enterprises. However, no refunds were received by the enterprises at the time of the survey.

While the inverted duty structure and the resulting blocked capital were the most important issues vis-à-vis the GST faced by the power loom sector in Surat that manufactures grey cloth, wholesalers and retailers in the textile and hosiery sector found that the GST compliance and paperwork made the movement of the unsold stock difficult for them. Previously, they could move unsold goods from one location to another, but this informal practice was severely restricted by the GST. This incapacity to move the unsold stock easily like before restricted the retailers as well as wholesalers from stocking more variety of items in their shops, curtailing their business practice.

For some of the businesses surveyed, long-standing buyer–supplier linkages were disrupted. This was especially true for the micro-units, where three-fourth of them reported facing difficulties due to disruptions in buyer–suppler linkages. A large part of their businesses was with unregistered clients who would not be willing to pay the GST. These units would then have to absorb the tax themselves or face losing market share. In some cases, where the enterprises shied away from giving concessions, they lost business with smaller units. In addition, some of the units reported having lost their clients as they had gone out of business. It was observed during the survey that whom you did business with mattered. If the business was with more established clientele, where the buyer–supplier networks were formalised with proper paperwork and so on before the GST, the units suffered less.

There were some other issues in play that are not captured directly in Table 6. One was the competition that businesses felt among themselves due to a multiplicity of tax rates on similar products. For example, the tax rate on woven elastics in the hosiery supply chain was 5%, whereas for braided elastics, it was 12%. Meanwhile, latex threads, an essential input to make elastics was taxed at 12% (from the previous VAT of 5%). Thus, woven elastic manufacturers were facing an inverted duty structure, which increased their input costs substantially, whereas braided elastic manufacturers had higher taxes on their products. Since the technology to manufacture these two types of elastics was different, it was not possible for the businesses to shift to woven elastics that easily, even though some did try to diversify their production; meanwhile, their sales suffered due to higher taxes.

Many of the enterprises felt that being under the tax net itself was not a problem, it was the complex nature and other factors identified above that posed a challenge. It was a combination of factors that disrupted the day-to-day functioning of the business through a breakdown of informal norms of doing business on the one hand and higher complexities on the other that affected them adversely.

Coping Mechanism: Adjustments in the Labour Market

Retrenchment of Workers

Due to adverse conditions of demand and a downturn in their turnover, an obvious route of coping for the enterprises surveyed in the year following the introduction of the GST was to fire workers. Of the enterprises surveyed, nearly 50% reported having retrenched workers after the introduction of the GST. In the labour-intensive power loom sector manufacturing grey cloth, 100% of the surveyed enterprises reported having retrenched workers, while 93% of the leather units surveyed reported working with lesser workers. The average employment per firm fell from 20 in the pre-GST period to 16.6 in the post-GST period (Figure 2).

The number of hired workers by three categories before and after the GST is shown in Figure 3. If the enterprise did not hire any worker at all, it is an own account enterprise (OAE) as per the NSSO definition. An establishment enterprise is one that has at least one hired worker. In our survey, 7.4% of the enterprises were OAEs; they belonged to the micro category of enterprises. Of the micro-enterprises and SMEs, 66.3% and 11.3%, respectively, were hiring at least one worker, but not more than nine workers, whereas 26% of the micro enterprises and 88.7% of the SMEs were hiring more than nine workers. In the months following the introduction of the GST, retrenchment was rampant. Many establishment firms turned OAEs as the percentage of micro-enterprises not hiring any worker increased from 7% to 18%. This was a coping mechanism for entrepreneurs unable to pay wages to their employees as production was cut. They were depending solely on their own and

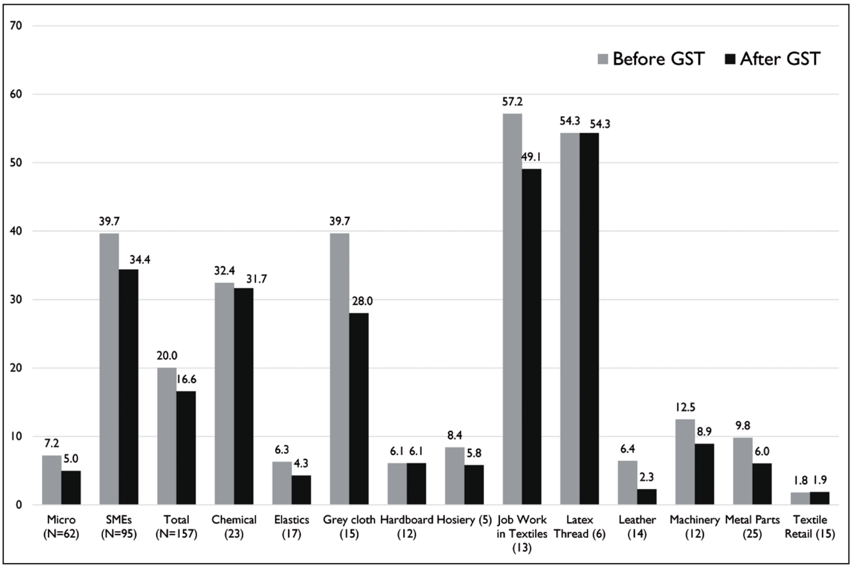

Figure 2. Average Employment Per Firm.

Source: Field survey.

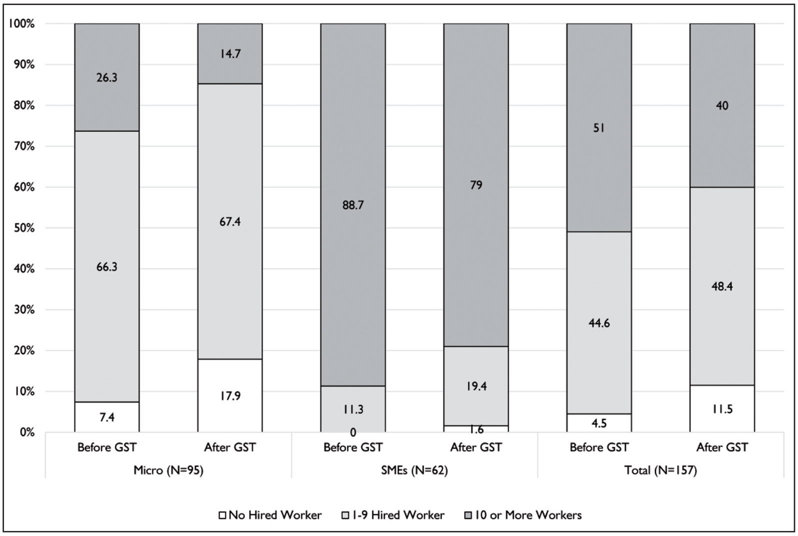

Figure 3. Percentage of Enterprises with Hired Workers (Pre- and Post-GST).

Source: Field survey.

family labour, letting go of all paid labour. This was also observed for one leather unit in the SME category; the enterprise had retrenched all its workers and was trying to sell off old stock and preparing to close. Due to retrenchment, the percentage of enterprises surveyed that hired more than nine workers also fell (26% to 15% for micro-units and 88.7% to 79% for SMEs), and the enterprises were now in the category of enterprises that hired 1–9 workers.

Since the unorganised sector with lesser capital intensities is much more labour-intensive than the organised sector, job losses in this sector due to the non-viability of their businesses have an intense ripple effect on the already weak demand situation in the country. The Periodic Labour Force Survey conducted between July 2017 and June 2018 provides evidence of widespread job losses (Mehrotra & Parida, 2019; NSO, 2019). Although growth was observed in employment in the organised sector, the total manufacturing employment fell in this period, which means job losses occurred in the unorganised sector.

Wage Bill Cut: A Case Study

There was a large-scale retrenchment in the power loom sector in Surat. The average employment per firm surveyed reduced from around 40 to 28 workers. The workers in this sector are paid on a piece-rate basis, weekly or monthly, depending on their arrangement with the employee. The work shifts are of 12 hours with no overtime for work done beyond eight hours. The workers we interviewed were all migrants from Ganjam District in Odisha who have worked in this sector for decades. After the introduction of the GST, following retrenchment, many of the workers we spoke to said that they were working on more machines than before. Earlier, a worker would work on 4–6 machines on average; now they were working on 6–8 machines, which meant further intensification of labour during each shift and being more swiftly 'on-foot' between the machines, with even lesser breaks. However, their total incomes would increase, as they were producing more cloth, even as the per meter wage rate was cut and the wage share in total output reduced.

The response to the crisis thus saw an increased brunt on the workers in this industry; the wage rate per unit of cloth was cut, from ₹1–₹1.25 per metre to ₹0.90–₹1.10, and the workers who remained in the industry were made to work on a greater number of machines.[1] They were not complaining as their aggregate income increased, even as the work took a greater toll on them. The conditions of work in this industry, like much of the unorganised sector, are deplorable and highly exploitative.

Formalisation of the Labour Market?

It is important to state here that though an enterprise employing 10 workers and more (and using power) is to mandatorily register under the Factories Act, we found a rampant violation of such registration. Although all of the enterprises surveyed were registered under one or the other act, a small percentage—all in the SME category—were registered under the Factories Act (3.82%) and the Companies Act (5.1%). These enterprises are a part of the 'formal' or 'organised' sector, and they assure social security and other benefits to their workers. The rest of the enterprises surveyed were in the unorganised sector; of these enterprises, a majority were registered with a license from the Municipal Corporation (59.24%), 14% were registered under the Shops and Establishment Act, 7.64% were registered under the Small Scale Industries Act and 10.19% were registered under the Proprietorship Act. However, as Mehrotra and Giri (2019) point out, these registrations—unlike registrations under the Factories Act—are mere registrations and not synonymous with formalisation. Certain benefits might accrue to the firms due to this registered status. The distribution of the enterprises by registration and employment size before the introduction of the GST is shown in Table 7.

As shown in Table 7, 4.46% of the enterprises had no hired workers (OAE as per the NSSO), whereas around 45% of the enterprises were working with 1–9 hired workers (the threshold for being in the informal sector when using electricity). Around 51% of the enterprises surveyed employed 10 or more hired workers; however, only 3.82% and 5.1% of them were registered under the Factories Act and the Companies Act, respectively. The rest of the enterprises in this group, irrespective of the number of persons employed, did not register under the Factories Act. This 'non-compliance' with the Factories Act was found to be the highest among enterprises that were registered under the Shops and Establishment Act (100%), followed by the Small Scale Industries Act (83%) and those having a *gumasta* license under a Municipal Corporation (37%). This finds resonance in the study of Chatterjee and Kanbur (2015) who used NSSO non-agricultural unincorporated enterprises survey data to show that a large number of

Table 7. Distribution of Employment Size by Registration under Various Acts (%).

Registration Status	No Hired Worker	1–9 Hired Worker	10 or More Hired Workers	Total	
Factories Act	0	0	100	100	(3.8)
Companies Act	0	0	100	100	(5.1)
Shops and Establishment Act	0	0	100	100	(14.0)
Municipal Corporation	1.1	62.4	36.5	100	(59.2)
Small Scale Industries Act	0	16.7	83.3	100	(7.6)
Proprietorship Act	37.5	62.5	0	100	(10.3)
Total	4.5	44.6	50.9	100	(100)

Source: Field survey, 2019.
Note: The percentage of total registration is presented in parentheses in the last column.

enterprises in the unorganised sector are non-compliant with the Factories Act.[2] Their study shows that this non-compliance is a key feature of the 'missing middle' in India.

Thus, a large number of enterprises that should be 'formal' by the employment criterion escape the status by being non-compliant. Our survey reveals that the status of an 'informal/unorganised enterprise' can very much be held, irrespective of legal or bureaucratic requirements for registration under the Factories Act. Needless to say, GST registrations did not change anything to move these enterprises into the 'formal' sector.

The evidence from our field surveys does not point to any aspect of formalisation of the labour market through the introduction of the indirect tax reform. This had no repercussions on the enrolment of workers into any schemes of social or protective welfare. Questions asked about paid leaves or enrolment into EPFO or ESIC showed no changes before or after the GST.

This registration forced the enterprises to bookkeep to comply with the GST. However, while bookkeeping on the transaction side became complicated for the entrepreneurs, when it came to workers, it remained the same, with informal 'pencil mark' notes and signatures to record names, working hours and wages received. An additional brunt was borne by their already vulnerable existence due to the GST. The informal sector entrepreneurs were under more duress themselves to sustain their businesses and they took recourse to retrenchment or wage rate cuts. The state bureaucracy has, to quote Hart (2006), 'made their [the informal sector's] search for self-preservation and improvement more difficult'.

Conclusions

The GST is meant to 'formalise' enterprises in India through an enterprise-based route and has impacted the informal sector in a number of ways: their ways of functioning, compliance mechanism and bookkeeping practices; their survival and subsistence; and the employment and wages for the workers employed in the sector. The adoption of the GST has been a huge departure from the past by bringing a large number of informal enterprises under the tax net. It has called upon a much greater need for bookkeeping and online filing of taxes than ever before. Importantly, the supply chains of the small businesses and their working capital have been affected due to the RCM and ITC system on the one hand and the matching of invoices on the other. The structure of the GST is such that exemptions towards certain threshold limits or schemes such as the composition scheme have limited beneficiaries as transactions—particularly B2B transactions—necessitate registration. Through disruption of informal norms of doing business, the GST has made the everydayness of businesses more difficult. While easing of the compliance mechanism through Sahaj and Sugam schemes makes the procedure simpler for businesses up to a turnover of ₹50 million, the GST is still a reform in the making.

Our study shows that the repercussions of the downturn in business for small businesses are borne by the workers in many instances, through retrenchment or through a cut in per-piece wage rates. This has been brought out at the macro-level by the PLFS data that show a decline in total manufacturing employment, even as the employment numbers of the organised sector have risen. Job losses have occurred in the unorganised sector. The self-employed in the informal sector have been rendered more vulnerable through the loss of business and the added work pressure to bookkeep. To formalise via registration into the tax net has borne out disproportionate stress on smaller enterprises to erode the meagre profit margins.

The ongoing pandemic has affected the MSMEs very severely, and state policies need to focus on the revival of the sector in a dedicated manner. Fixing some of the glitches caused by the hasty adoption of the GST will also need to be a part of the policy directives. This article, though based on a small sample of enterprises, throws some light on the processes and channels that need to be kept in mind considering the ground realities faced by the MSMEs. Although a quest towards formalisation offers many benefits to both the enterprises and their workers, future endeavours to inject a greater degree of formalisation should be more cautious, particularly for more vulnerable sections of society. The Indian experience with the GST holds lessons for other developing countries as well.

Acknowledgements

This article is part of an ISID project titled *Understanding Criticality of Flow of Funds for Robust Growth of MSMEs* sponsored by Public Sector Banks. I owe my deep gratitude to the Aajeevika Bureau for their help in conducting the survey in Mumbai and Surat. I am grateful to the Confederation of Indian Industries for their help in Delhi. I thank Sourindra Mohan Ghosh for his helpful comments on an earlier draft. I am grateful to two anonymous reviewers of this journal for their insightful comments.

Declaration of Conflicting Interests

The author declared no potential conflicts of interest with respect to the research, authorship and/or publication of this article.

Funding

The author received no financial support for the research, authorship and/or publication of this article.

ORCID iD

Sangeeta Ghosh https://orcid.org/0000-0003-1847-678X

Notes

1. The per-piece rate varied by the quality of cloth, the machinery used and the location of the enterprise.
2. Here, non-compliance is used in a limited sense to mean non-registration alone. A mere registration into the Factories Act would not of course mean that the firms are compliant to all aspects of the law (Chatterjee & Kanbur, 2015).

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