



## **Effect of GST on Small and Medium Enterprises (SMEs) in India**

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### **ABSTRACT**

The implementation of the Goods and Services Tax (GST) in India marked a significant reform in the indirect taxation system, aiming to unify multiple taxes into a single, transparent framework. This study examines the impact of GST on Small and Medium Enterprises (SMEs), which constitute a vital segment of the Indian economy in terms of employment generation and contribution to GDP. The research highlights both the positive and negative effects of GST on SMEs. On the positive side, GST has simplified the tax structure, improved compliance through digitalization, and facilitated easier interstate trade by eliminating cascading taxes. However, SMEs have also faced challenges such as increased compliance costs, complex return filing procedures, and the need for technological adaptation. The study further explores how GST has influenced business operations, working capital management, and competitiveness among SMEs. Overall, while GST has enhanced transparency and long-term efficiency, its initial implementation posed significant transitional difficulties for small businesses. The paper concludes that continuous policy support and simplification measures are essential to ensure sustainable growth of SMEs under the GST regime.

### **Keywords**

GST, Small and Medium Enterprises, Tax Reform, Compliance Cost, Digitalization, Indian Economy, Business Performance, Working Capital

### **1. INTRODUCTION**

The Goods and Services Tax (GST), implemented in India on 1st July 2017, is one of the most significant reforms in the country's taxation system. It replaced a complex structure of indirect taxes, such as VAT, service tax, excise duty, and various state-level entry taxes, with a single unified tax regime. The main goal of GST is to simplify the tax system, reduce the cascading effect of multiple taxes, create a common national market, and improve compliance.

SMEs play a crucial role in the Indian economy. They contribute significantly to employment generation, industrial output, and export promotion. Before GST, SMEs faced numerous challenges, including multiple tax compliance requirements, high logistics costs due to state entry taxes, and lack of uniformity in taxation across regions. The introduction of GST brought both opportunities and challenges for SMEs. On one hand, it created a simplified tax environment with benefits like input tax credit and wider market access. On the other hand, it introduced new compliance requirements, digital literacy demands, and liquidity issues.



Understanding the impact of GST on SMEs is important because these enterprises form the backbone of the economy and are critical to sustainable growth.

## **2. POSITIVE EFFECTS OF GST ON SMES**

### **a) Simplified Tax Structure**

Before GST, SMEs had to comply with multiple taxes levied by both the central and state governments, such as excise duty, VAT, service tax, and local entry taxes. Each of these taxes had its own rules, rates, and filing procedures, which created confusion and inefficiency, especially for small businesses with limited resources. GST replaced all these multiple taxes with a single tax framework, unifying indirect taxes under one system. This has greatly simplified accounting, billing, and compliance processes for SMEs.

The unified tax regime eliminates overlapping tax structures and reduces the cascading effect of taxes, ensuring that SMEs are taxed only on the value added at each stage. By simplifying the tax structure, GST reduces compliance-related stress and allows SMEs to focus more on business operations and growth rather than navigating a complex tax environment. Furthermore, a simplified tax regime ensures predictability in taxation, enabling better financial planning and pricing strategies for SMEs, which is crucial in a competitive market.

### **b) Input Tax Credit (ITC) Benefits**

One of the most significant advantages of GST for SMEs is the availability of the **Input Tax Credit (ITC)**. Under GST, businesses can claim credit for the tax paid on purchases of raw materials, services, and capital goods. This means that SMEs do not pay tax on the entire value of their output but only on the value addition they make. ITC eliminates the cascading effect of taxes, reducing the overall tax liability for businesses.

For SMEs, which often operate with thin profit margins, the ITC benefit translates into substantial cost savings. It also encourages better record-keeping and accounting practices, as only registered and documented transactions qualify for credit. Over time, ITC improves financial discipline and helps SMEs manage working capital more effectively. Moreover, the ability to claim ITC encourages SMEs to source goods and services from other GST-registered businesses, further formalizing the supply chain and contributing to a more transparent business ecosystem.

### **c) Wider Market Access**

Before GST, interstate trade for SMEs was often cumbersome due to entry taxes, octroi, and state-level VAT differences. Each state had its own regulations and procedures, which created logistical challenges and increased the cost of doing business across regions. GST has eliminated these barriers, enabling SMEs to sell their products across India without additional state-level taxes.

The removal of interstate barriers allows SMEs to expand their markets beyond their local region, opening up opportunities for growth, increased revenue, and diversification of customer



bases. With GST, the cost of logistics and transportation is more predictable, and businesses can plan supply chains more efficiently. By providing a level playing field, GST allows SMEs to compete with larger enterprises in national markets, giving them the opportunity to scale their operations and reach new customers.

#### **d) Formalization of Business**

GST has incentivized SMEs to formalize their businesses. Registration under GST is mandatory to collect and claim tax credits, encouraging small enterprises to enter the formal economy. Formal registration has multiple advantages, such as improved credibility with customers and suppliers, easier access to banking services, and eligibility for government loans, subsidies, and schemes aimed at supporting small businesses.

For SMEs, formalization under GST provides a structured framework for financial reporting and taxation. It also fosters transparency in operations, making them more attractive to investors and partners. Over time, formalization under GST contributes to building a more robust business ecosystem where SMEs can access finance, integrate with larger supply chains, and compete on a national level with better compliance and accountability.

#### **e) Increased Transparency**

GST requires electronic filing of returns, e-invoicing, and real-time reporting of transactions. This ensures that business operations are transparent, reducing the chances of underreporting or tax evasion. For SMEs, increased transparency builds trust with customers, suppliers, and financial institutions, which is critical for business growth and long-term sustainability.

By maintaining proper records and ensuring compliance, SMEs can avoid legal disputes and penalties. Transparency also enables better creditworthiness, making it easier for small businesses to secure loans and financing. In addition, digital records under GST provide insights into business performance, helping SMEs make informed decisions about expansion, pricing, and supply chain management.

### **3. CHALLENGES FACED BY SMES UNDER GST**

#### **a) Compliance Burden**

While GST simplifies taxation in the long run, it also imposes a compliance burden on SMEs. Businesses are required to file monthly or quarterly returns, maintain detailed invoices, and reconcile accounts accurately. Small enterprises, especially those with limited accounting staff, may find it difficult to meet these requirements.

The compliance process can be time-consuming and costly, as many SMEs need to invest in accounting software or hire professional assistance. Failure to comply with GST rules can result in penalties, interest, and legal disputes, making it a significant challenge for smaller businesses that operate on limited resources.

#### **b) Cash Flow Pressure**



Under GST, SMEs often pay taxes upfront on goods and services purchased before claiming input tax credits. This can strain liquidity, particularly for businesses with low working capital or delayed payments from customers. Delays in receiving refunds or credit claims exacerbate cash flow problems.

For SMEs, cash flow is critical for daily operations, including procurement, payroll, and expansion activities. Any disruption due to upfront tax payments can hinder growth and operational efficiency. Therefore, managing cash flow becomes an essential part of financial planning under the GST regime.

#### **c) Technology and Digital Literacy**

GST requires online registration, digital filing of returns, and e-invoicing. SMEs that lack IT infrastructure or have low digital literacy often face difficulties adapting to these requirements.

Adopting technology incurs costs for software, training, and sometimes hiring skilled personnel. For micro and small enterprises, this can be a significant barrier, delaying compliance and creating initial confusion during the GST rollout.

#### **d) Multiple Tax Slabs**

GST has different tax rates, including 5%, 12%, 18%, and 28%, depending on the category of goods or services. SMEs need to classify products correctly to avoid penalties. Misclassification can lead to disputes with tax authorities, interest on unpaid taxes, or legal complications.

Managing multiple slabs adds complexity to accounting and pricing strategies. SMEs need to invest in proper accounting and tax software to ensure correct classification and reporting, which can increase operational costs.

#### **e) Initial Transition Issues**

During the initial phase of GST implementation, SMEs faced several challenges, including understanding registration requirements, ITC claims, return filing, and adapting to new digital processes. Many businesses were unprepared for the transition, causing disruptions in operations and delays in compliance.

Training and adaptation took time, and some SMEs faced temporary financial and administrative strain. While most issues have been resolved over time, the initial transition period highlighted the need for better support and awareness programs for SMEs.

### **4. OVERALL IMPACT ON SMES**

GST has had a mixed impact on SMEs in India. On the positive side, it has simplified taxation, provided input tax credits, encouraged formalization, increased transparency, and enabled wider market access. On the negative side, SMEs face compliance burdens, cash flow pressures, technology challenges, and difficulties in navigating multiple tax slabs.

Long-term benefits include improved competitiveness, access to credit, and integration into national supply chains. The short-term challenges, however, require SMEs to invest in proper accounting, training, and digital infrastructure to fully leverage the advantages of GST.



## **5. CONCLUSION**

GST has fundamentally transformed the business environment for SMEs in India. While the system simplifies taxes and creates opportunities for expansion, it also demands higher compliance, digital literacy, and cash flow management.

For SMEs to fully benefit, support from the government, such as training programs, simplified processes, and digital tools, is essential. With proper adaptation, GST can strengthen SMEs by enhancing competitiveness, increasing market reach, and formalizing business operations, making them more resilient and growth-oriented in the long term.

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