MSMEs in the GST Regime: Insights from a Survey

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Small Business, Big Reforms (EPW, 2020) and Formalising the Informal, Evidence from a Survey of MSMEs (RDC, 2022)

ISID Project on MSMEs: Survey Dec 2018-March 2019

Taxing the Informal Economy

- The relationship between the informal economy and taxation is an important but under-researched policy issue.
- For India, the intensity is higher due to the sheer size of the informal economy as well as the dependence of people on the sector for their lives and livelihoods. After GST was rolled out in 2017, media reports and reports by industry associations have frequently brought to the fore the myriad challenges faced by small businesses w.r.t. GST.
- The multiple and frequent changes brought out by the GST Council are reflective of the need to tweak the rolled-out GST particularly with respect to MSMEs.
- However, the lack of macro data has restricted informed research on these issues.
- Thus, this study examines the processes and channels through which the indirect tax reform in India affected MSMEs drawing insights from primary surveys.

How is GST a departure from the past to affect small businesses?

- **Much wider coverage of enterprises**
  - Both goods and services
  - Turnover more than Rs 10/20/40 lakhs depending on line of business and state
  - Composition scheme for taxpayers with turnover less than Rs 1 crore/Rs 1.5 crore
- Input Tax Credits – entire value chain
- Reverse Charge Mechanism – recipient of goods/services pays the tax
- **Invoice Matching to claim input tax credit**

  =>> **self-policing mechanism**

  cannot claim ITC unless registered

  reluctance of businesses to buy in B2B if not registered – thus an implicit pressure to register especially in B2B transactions even if eligible for Composition Scheme

  affects buyer-supplier relations
- More frequent filing of returns
- **High IT dependence**

  =>> higher compliance costs

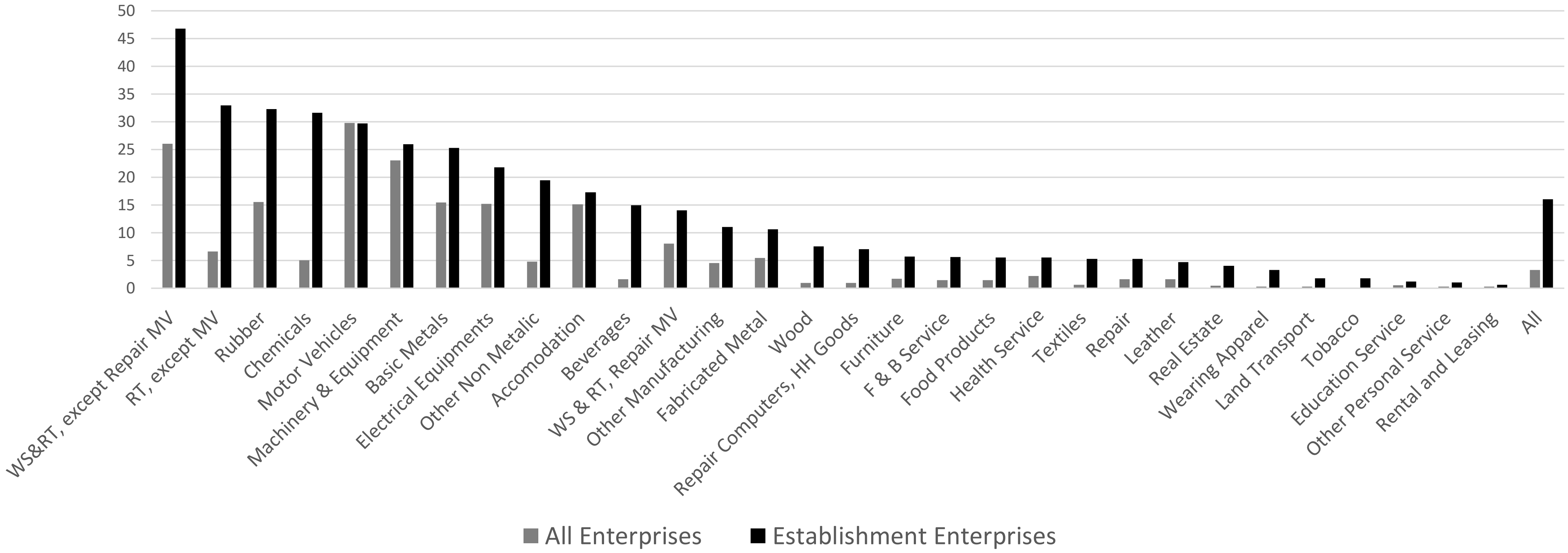
Kanbur and Keen (2014) Thresholds, informality and partitions of compliance. *International Tax and Public Finance* 21, 536–559.

Five Categories of Compliance

- Microenterprises – below tax threshold, taxes do not apply
- Adjusters – adjust by lowering sales to just below tax threshold
- Ghosts – do not pay taxes at all
- Partial Evaders – under declare sales to evade taxes partially
- Compliers – full declaration of sales and remittance of tax

GST inherently institutionalises a coercive tendency to bring the "microenterprises" in the above categorisation – outside the tax ambit, to register, even if they are filing Nil taxes. This is a departure from the past.

Unorganised Sector Enterprises Registered under VAT/Sales Tax (2015-16)



Only 3.8% of unorganised enterprises registered under VAT/Sales Tax.

NDMEs and DMEs – 16%.

Source: NSSO 73rd Round, 2015-16

The scenario now:

- Total registrations under GST as on 30 June 2022 were 13.83 million, of which normal taxpayers accounted for 86.6% and composition taxpayers were around 11.5%.
- Of the total registrations, 34% migrated from pre-GST regime, while **66% were new registrations** (GST Council Report, 2022).
- The service sector and large sections of small businesses account for these new registrations that include certain commodities exempted from taxes in the previous regime.

As of June 30, 2022 (GST Council)	**(in million)**	**(% of total)**
Normal Tax Payers	11.97	86.59
Composition Scheme	1.59	11.47
Others	0.27	1.94
Total	13.83	100
Migrated from Pre-GST	4.71	34.05
New Registrations	9.12	65.95
Unincorporated Enterprise Taxpayers in 2015-16 (3.38% of all enterprises)	2.41 million	

Survey Methodology

- Primary Survey of **157 MSMEs in Delhi, Mumbai, and Surat from December 2018 to March 2019**.
- Respondents: Owners, Managers, Accountants, Workers as per availability of the resource persons
- **Structured Questionnaires and Unstructured Interviews** to complement the data.
- **Snowballing** to identify enterprises. **To avoid biasness**, we selected the first units of survey purposely to ensure diversity in the size structure, product lines, activity, type of business, and so on.
- Whenever possible, **we tried to follow up on a supply chain**.
- For Example:
- Surat: grey cloth manufacturers > > traders > [dye factory – large unit] >manufacturers of dyes intermediaries >> embroidery units who performed job-work on dyed cloth given to them by the trader >> wholesalers >> retailers.
- Surat and Delhi: Latex rubber manufacturers >> knitted and braided elastic manufacturers >> elastic traders in Delhi >> hosiery manufacturing units that used elastics and fabric as main inputs >> retail traders.
- Mumbai: Leather industry: leather hide traders >> manufacturers of various types of leather items >> traders of metal chains, rings, handles that are used to make leather products >> retail outlets.
- Tracing these product lines and businesses that did **inter-related and inter-dependent business** when possible was important so as **to understand the impact their businesses had on one another**.
- Limitations: **Small sample - MSME sector -large and variegated in its business practises. The results are largely qualitative in nature.** Hope is to understand the processes and channels through which it has impacted small businesses and explore dimensions of informality and its interactions with the taxation system

Description of the Enterprises Surveyed

	Micro (N=95) (60%)	SME (N=62) (40%)	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
Book Keeping before GST			
Yes	73.7	98.4	83.4
Digital Book Keeping	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

MSMEs under GST

- 93% of the businesses surveyed took registrations under GST irrespective of their annual turnover.
- Category I – Exempted under GST with a turnover of less than Rs 20 lakhs (6.4%)
- Category II – could opt for composition scheme - 51%
- Category III – Mandatory registration - 43%
- Many of the enterprises in Category I and II took GST registrations.
- 70% of exempted class took reg.
- CS eligible units in Category II, 90% took reg, only 8.75% actually registered under CS.
- Our sample shows such high registrations into GST as 76% were in B2B transactions. Enterprises in B2B transactions face an implicit pressure to register under GST due to ITC, RCM and supply chain-related pressures.
- The 32nd GST Council Minutes (2019) reveal that around 22% of those eligible for composition scheme had opted for the scheme while the rest choose to register under GST. Thus, we see that irrespective of the turnover thresholds, enterprises were registering under GST.

Registration into GST by Turnover Distribution* (Field Survey)

Turnover Distribution	Yes	Composition Scheme	No	Total	
Category I: < Rs 20 Lakhs	70	0	30	100	(6.37)
Category II: > Rs 20 lakhs & < Rs 1 crore	90	8.75	1.25	100	(50.95)
Category III: > 1 crore	100	0	0	100	(42.68)
Total	92.99	4.46	2.55	100	(100)

* Verification of annual records of the units was not possible. Even NSSO rounds report only 12% of the enterprises maintain a book of account and 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 Rs 20 lakh, Rs 20 Lakhs to Rs 1 Crore, More than Rs 1 Crore, was useful in data collection.

Effect on Perceived Monthly Turnover by Enterprise Type (%)

- Of the enterprises surveyed, 53% 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.
- Micro-enterprises reported facing a greater reduction in their turnover than SMEs.

Effect on Perceived Monthly Turnover by Enterprise Type (%)

	Reduced by 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				

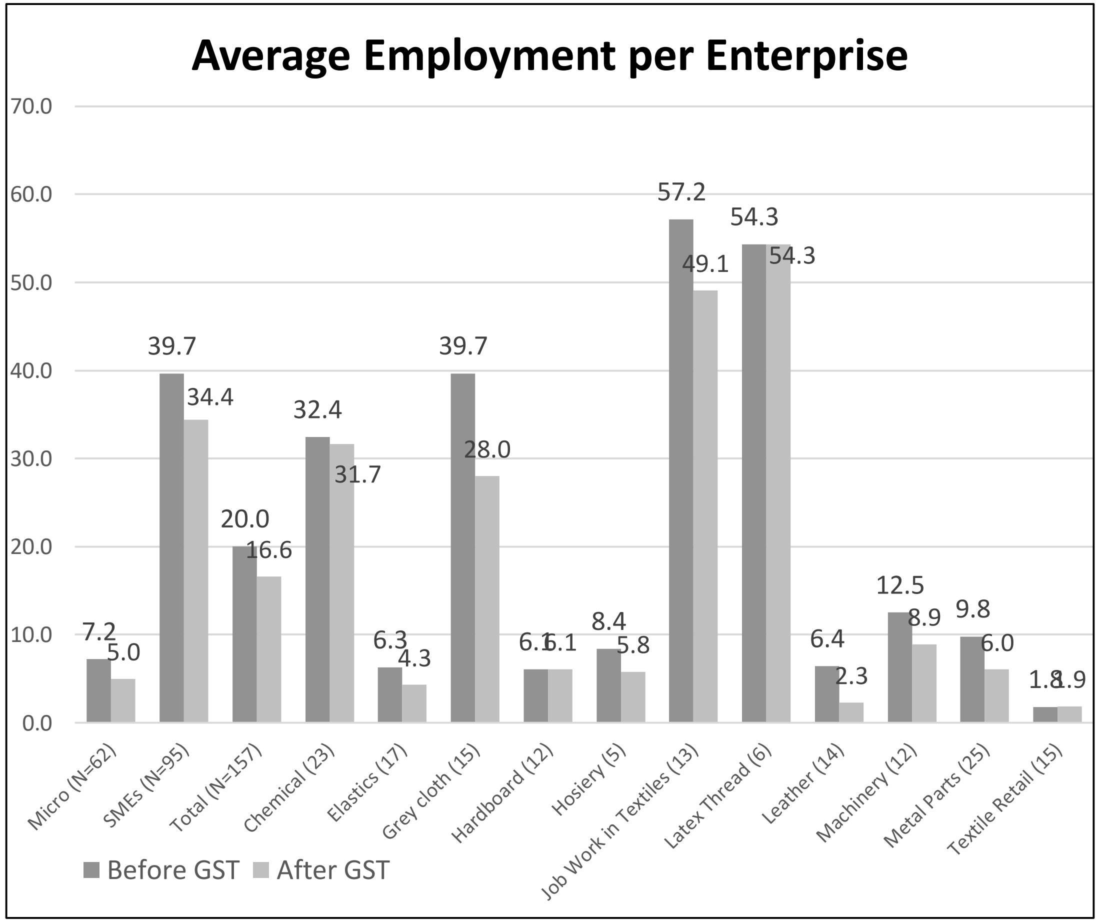
Perceived Reasons Constraining Business

- Time of Implementation – eight months after demonetisation:
- Lack of Demand: 90%
- Compliance Costs: 82% (first time tax payers, unaccustomed to elaborate and complex bookkeeping. Unfamiliar with ITC, many hired part-time/ full-time CA, shared CA, bought computers in small spaces, family help to book keep. Digitalising meant increased labour)
- Blocked Working Capital: 59% (paying taxes before the circle of payment was complete resulted in blocked capital; payments made after final sale).
- Greater Delay in Payments: 45% (increased to 75-90 days as related businesses were under duress)
- Inverted Duty Structure: 21% (specific to sectors, powerloom – yarn 18%, 12%, grey cloth at 5%, blocked capital)
- Restrictions to Flexibility of Movement of Stock: 21% (wholesalers and retailers, paperwork, could not stock more, informal practise of moving goods curtailed)
- Buyer Supplier Linkages: 55% (micro units, unreg clients – not willing to pay GST, either absorb tax or lose market share; clients went out of business; whom you did business with mattered – with established clientele where networks were formalised even before GST, units suffered less)
- Multiplicity of taxes on similar products. For example, woven elastics in the hosiery supply chain was taxed at 5%, braided elastics at 12%. Meanwhile, latex threads, an essential input to make elastics was taxed at 12% (up from VAT of 5%). 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.
- These factors overlapped and played their roles in various businesses in different ways

Type of Unit/ Product Lines	Reasons Constraining Viability of Business after GST							No. of Units Surveyed
	Lack of Demand	Blocked Working Capital	Inverted Duty Structure	Greater Delay in Payments	Compliance Costs	Buyer-Supplier Linkages	Restrictions to movement of goods	
Micro Units	**96.8**	**57.9**	**12.6**	**60**	**85.3**	**74.7**	**27.4**	**95**
SMEs	**80.6**	**59.7**	**33.9**	**21**	**75.8**	**25.8**	**11.3**	**62**
Chemical	87	69.6	30.4	34.8	69.6	69.6	0	23
Elastics	100	64.7	64.7	100	100	100	0	17
Grey cloth	100	100	100	0	100	0	0	15
Hardboard	100	0	0	0	100	100	0	12
Hosiery	80	0	0	0	100	100	60	5
Job Work in Textiles	61.5	0	0	0	69.2	0	0	13
Latex Thread	100	100	0	100	100	100	0	6
Leather	100	85.7	0	100	64.3	0	100	14
Machinery	66.7	41.7	0	41.7	66.7	41.7	0	12
Metal	92	84	0	56	100	80	4	25
Textile and Hosiery Retail	100	40	0	40	40	40	100	15
Total	**90.4**	**58.6**	**21**	**44.6**	**81.5**	**55.4**	**21**	**157**

Product	Benefits			No. of Sample Units
	Ease of ITC Claims	Inter-state Trade; E-way Bill	Ease of Compliance	
Total	**38.9**	**47.8**	**8.9**	**157**
Chemical	100.0	87.0	30.4	23
Elastics	64.7	100.0	0.0	17
Grey cloth	0.0	0.0	0.0	15
Hardboard	0.0	100.0	0.0	12
Hosiery	0.0	0.0	0.0	5
Job Work in Textiles	100.0	53.8	23.1	13
Latex Thread	16.7	0.0	0.0	6
Leather	0.0	64.3	0.0	14
Machinery	58.3	58.3	33.3	12
Metal	24.0	12.0	0.0	25
Textile and Hosiery Retail	0.0	0.0	0.0	15

Coping Mechanism: Retrenchment of Workers



- Nearly 50% retrenched workers
- Powerloom sector - All, Leather Units - 93%
- Many became OAE by retrenched all hired workers (from 7% to 18%)
- Wage Cuts
- PLFS 2017-18 shows job-loss in unorganised sector

Conclusions

- The GST has meant to ‘formalise’ enterprises in India through an enterprise-based route and has impacted the informal sector, their functioning, compliance mechanism and book keeping practises, their survival and subsistence, as well as employment and wages for the workers employed in the sector.
- The adoption of GST has been a huge departure from the past by bringing a large number of informal enterprises under a tax net.
- It has called upon a much greater need for record keeping an online filing of taxes than ever before. Importantly, the supply chains of the small businesses and their working capital of has been affected due to the reverse charge mechanism and input tax credit system on one hand, and the matching of invoices on the other.
- The structure of GST is such that exemptions towards certain threshold limits or schemes such as composition scheme have limited beneficiaries as transactions, particularly B2B transactions necessitate registration.
- While easing of the compliance mechanism through Sahaj and Sugam schemes make the procedure simpler for businesses up to a turnover of Rs 5 crore, GST is still a reform in making.
- The on-going pandemic has affected the MSMEs in a very severe manner 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 GST will also need to a part of the policy directives.
- While a quest towards formalisation offers many benefits to both the enterprises as well its workers, future endeavours to inject a greater degree of formalisation should be more cautious particularly for more vulnerable sections of the society. The Indian experience with GST holds lessons for other developing countries as well as for India.

Thank you

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