

GST Compliance Burden on MSMEs in India: Challenges and Simplification Needed: A Secondary Data-Based Study

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ABSTRACT

The Goods and Services Tax (GST) was launched in India in July 2017, and was designed as a major change in the indirect tax system, bringing it together under one roof for India. Although the reform has made tremendous progress in the formalisation of the economy, and removed cascading tax impacts, the effect has been far from uniform or consistent in relation to Micro, Small and Medium Enterprises (MSMEs). Despite the MSMEs' significant contribution to the Indian economy, contributing around 29-30% to GDP, more than 26 crore of people are employed in this sector, and nearly 45.73% of the exports in FY 2023-24 happen from this sector, there are still many compliance burdens faced by the MSMEs. This paper explores, in the light of secondary data and literature, the various compliance issues that are faced by MSMEs in the implementation of GST – such as the complexity of GST returns, inverted duty structure, delayed ITC refunds, the lack of digital infrastructure and the high compliance cost. It also reviews the latest policy measures and any new measures that have been undertaken to simplify under the GST 2.0 regime and offers targeted suggestions for developing a more MSME-friendly tax system.

Keywords: GST, MSME, Tax Compliance, India, Indirect Taxation, Input Tax Credit, GST 2.0, QRMP Scheme, Composition Scheme, Tax Simplification

1. Introduction

One of the most important changes in the fiscal history of India was the enactment of the Goods and Services Tax (GST) from July 1, 2017. GST and the concept of 'One Nation, One Tax, One Market' meant the merging of more than 17 indirect taxes at the central and state levels. The reform in theory would be able to reduce the cascading effect of multiple taxes, establish a national market and decrease all the compliance obligations on firms of every size.

But for Micro, Small and Medium Enterprises (MSMEs), the fact has been much more complex. MSMEs are a microcosm of businesses — ranging from artisans, craftsmen, and ragpickers in rural regions, to small workshops and service providers in urban areas, as well as medium-sized manufacturers and service providers. Limited resources, thin margins and informal operating structures were expected to have the greatest potential to benefit from GST, for MSMEs. Rather, they've found themselves facing challenges such as rising compliance requirements, disjointed processes, and financial pressures.

This paper aims to explore the compliance issues that GST has brought out for Indian MSMEs based on secondary data collected from government reports, industry surveys, Parliamentary committee reports, and academic research. It also reviews the recent policy changes and the structural simplification requirements that need to be tackled to make sure that GST is a boon for India's small business community and not a burden on them.

2. The MSME Sector: Economic Significance and Structural Profile

The MSME sector in India is one of the largest and most diversified in the world. The Udyam/UDYAM Assist portal data (2024) reveals that currently, India has more than 5.9 crore MSMEs and over 26 crore workers working in the MSME sector, which is the 2nd largest industry workforce after Agriculture.

Table 1: Key Economic Indicators of India's MSME Sector

Indicator	Data / Figure
Total Registered MSMEs (2024)	Over 5.9 crore
Total Employment Generated	More than 26 crore workers
Contribution to GDP	~29–30.1%

Indicator	Data / Figure
Share of Manufacturing GVA	~41%
Share of Total Exports (FY 2023-24)	45.73%
GST-Registered MSMEs (Dec 2024)	~1.5 crore (from ~5 lakh in 2017-18)

Sources: Udyam/UDYAM Assist Portal (2024); Ministry of MSME; PHDCCI (2025); Binary Semantics GST Study (2025)

However, MSMEs are structurally disadvantaged in dealing with complex regulatory environments, despite their economic importance. They are mostly sole proprietorships or partnerships where there are limited people, limited IT resources and limited financial resources. The structural features mean they are seriously disadvantaged in comparison to larger businesses in absorbing compliance requirements of a broad-based tax regime such as GST.

3. GST Framework and Its Design Implications for MSMEs

In India, the GST system is a dual GST system with two parts: Central GST (CGST) and State GST (SGST) for intra-state transactions, and Integrated GST (IGST) for inter-state transactions. The system employs an invoice-matching mechanism to allow Input Tax Credit (ITC) claims, and periodic return filing in the GSTN portal.

Initially, there were four broad tax rates: 5%, 12%, 18% and 28%, a cess for demerit and luxury goods and a 0% rate for essential goods. Although the tiered structure was designed to be flexible and fair, it created a lot of confusion in classification and compliance, particularly for MSMEs with multiple product categories and mixed supplies.

Additional provisions were also made in the GST law just to soften the impact for smaller businesses. These include the Composition Scheme (for annual turnover of up to ₹1.5 crore), QRMP (Quarterly Return Filing and Monthly Payment) scheme applicable to businesses with annual turnover of up to ₹5 crore and a threshold exemption of ₹40 lakh for businesses engaged in the supply of goods. These provisions, however, have not been widely accessible and are subject to their own limitations, as this paper will show.

4. GST Compliance Challenges Faced by MSMEs: An Analysis

4.1 High Frequency and Volume of Return Filings

One of the most important aspects of GST is return filing which occurs frequently and is quite complex. In a typical case, a regular GST taxpayer has to submit around 25 returns annually, including at least 2 monthly returns (GSTR-1 and GSTR-3B) and 1 annual return (GSTR-9). This is a heavy burden for MSMEs having small teams.

The impact on GST compliance is starkly illustrated in a study undertaken in 2025 which estimated that it costs the micro enterprise about 28.6 hours of their month on GST related activities including filing, reconciliation and responding to tax department notices. Medium businesses spend about 15.7 hours per month and small businesses spend about 21.4 hours per month. This is a substantial production loss for a small group of 3-5 people.

4.2 Complexity of Multi-Rate Tax Structure

The multi-slab GST structure, which was initially five rates (0%, 5%, 12%, 18%, 28%), has caused significant classification issues for MSMEs. Often, many small businesses may lack such professional expertise or afford it to achieve correct categorisation of goods and services under the appropriate Harmonised System of Nomenclature (HSN) code and corresponding tax rate. This is made harder by the constant rate changes.

The survey results from IJCRT (2025) indicated that 55% of MSMEs in Mumbai observed that taxations under GST are becoming more complex, 60% of them noted that they are facing more operational costs, while 65% of them faced severe compliance issues. The results align with the national trends reported by Deloitte in their survey GST@7 (2024) which reported that the acceptance rate for GST among MSMEs has increased (78% were favorable towards GST in 2024, compared to 66% in 2023) but compliancers were still common among them.

4.3 Input Tax Credit Delays and Working Capital Stress

The Input Tax Credit (ITC) has come up as a financial burden for several MSMEs, which is supposed to eliminate cascading taxation. But GST claim by ITC can only be made subject to the filing compliance of the suppliers. In case an MSME's supplier fails to file GSTR-1 or if there is a mistake in their return, the MSME will not be able to avail ITC on the purchases made from the supplier, which will actually result in an increase in their effective tax liability.

This further results in an asymmetric structure of relationships between large firms and MSMEs. Payments are delayed by up to four months by large businesses, who are dependent on MSME suppliers, until ITC claims are settled, thus

denying them access to working capital. Further, the QRMP scheme also provides relief to allow MSMEs to submit monthly returns instead of quarterly returns, but larger buyers are often pressuring them into doing so.

Refund delays create an acute liquidity crisis for the exporters among MSMEs. If the exports are zero rated under GST then exporters are eligible for ITC refunds on inputs. The delays in processing these refunds, however, due to inefficiency in the portal and documentation requirements have heavily affected the cash flow of export-oriented MSMEs.

4.4 Inverted Duty Structure

When the rate of GST on inputs (raw materials) is higher than the rate on the final product/ output, this is an inverted duty structure. This leaves accumulated unused ITC which businesses are not able to use, effectively tying up working capital.

The issue is more pronounced in sectors like spare parts makers, finished tractor makers (to which 12% tax is applicable), sanitaryware and tiles makers, textile intermediaries, and pharmaceuticals makers where the input rate is 18%. The inverted duty structure has been reported as a significant barrier for competitiveness and growth in Morbi, Gujarat, where MSMEs make up about 80% of the country's tile production.

4.5 Digital Infrastructure and Digital Literacy Gaps

It is a natural fact that GST is a technology-based system. Registration, generation of invoice, return filing, ITC reconciliation, and claiming refunds are all completed online on the GSTN portal, so a robust internet connection, accounting software that is compatible with the GSTN and digital literacy are essential.

The digital infrastructure for MSMEs is still underdeveloped, especially in semi-urban and rural areas, particularly in states like Bihar, Jharkhand, Uttar Pradesh, Chhattisgarh and in parts of the Northeast. The rates of compliance and registration of GST in these regions are not more than 40-50%, whereas in technologically advanced states like Tamil Nadu and Karnataka it is more than 80%. Smaller businesses have faced significant challenges due to poor internet connectivity and low level of digital literacy, which have affected their utilisation of the GSTN interface.

Some technical glitches on the GST portal have also been an ongoing issue. MSMEs without the resources to challenge or absorb these disruptions are facing errors, penalties and legal disputes as a result of system downtimes, mismatches of auto-populated data and actual filings, and compatibility errors.

4.6 High Compliance Costs

The cost of GST compliance is not just in terms of filing fees. MSMEs need to purchase accounting software that is GST compatible, have to hire professional tax consultants/chartered accountants, and in some instances, employ dedicated compliance personnel. These expenses, though small in numbers, appear to be disproportionate to the rates of turnover and profit of micro and small enterprises.

The businesses dealing in interstate trade are subjected to further requirement, i.e. registration in various states of GST. Whereas once a single national registration was enough in the pre-GST days, the GST regime necessitates multiple registrations in each state in which a business operates, adding to administrative burden and complexity. The Parliamentary Committee report (2025) explicitly pointed to this issue and suggested the creation of a unique business ID to keep a central record of multi-state registrations.

4.7 Frequent Legislative and Rate Changes

The GST framework has been subject to several changes since its launch — such as those in the return formats, rate changes, filing timeline extensions, and new provisions like e-invoicing, QR codes and HSN codes. Most of these changes were supposed to make the system better, but they've added to the uncertainty and compliance costs to smaller businesses.

The initial enthusiasm of the MSMEs on the GST has been marred by policy changes and lack of proper facilitation mechanisms, says the academic research published in The Economics Journal, 2025. High rates of regulatory changes and a lack of awareness and training support at the grassroots level have led to a compliance environment that is significantly disadvantageous for small businesses.

Table 2: Summary of Key GST Compliance Challenges for MSMEs

Challenge Area	Nature of Impact	MSMEs Most Affected
Return Filing Burden	~25 returns/year; 28.6 hrs/month for micro firms	Micro enterprises
Multi-Rate Structure	Classification disputes, frequent revisions	All MSMEs
ITC Delays	Cash flow stress, payment withheld by buyers	Exporters, supply chain MSMEs
Inverted Duty Structure	Blocked ITC, eroded margins	Spare parts, tiles, textiles
Digital Infrastructure Gaps	Low GSTN adoption in lagging states (40–50%)	Rural, semi-urban MSMEs
High Compliance Costs	Software, CA fees, multi-state registrations	Multi-state operators
Legislative Volatility	Uncertainty, frequent system adaptations needed	All MSMEs

Sources: Compiled from Binary Semantics (2025), IJCRT (2025), The Wire/FLAME (2025), RJA/CA Rajput (2026), The Economics Journal (2025)

5. Policy Interventions and Government Responses

5.1 Composition Scheme

Under the Composition Scheme, MSMEs with an annual turnover of not more than ₹1.5 crore get to file a single quarterly return instead of multiple monthly returns, and pay a flat rate of tax (between 1% and 6% depending on the type of business). This substantially lowers traders and manufacturers' compliance expenses. But the scheme may not be as helpful for the growth-oriented or export-active MSMEs because ITC cannot be claimed by the composition dealers and they cannot make inter-state supplies.

5.2 QRMP Scheme

The Quarterly Return Filing & Monthly Payment Scheme (QRMP) is introduced in January 2021 for taxpayers with an annual turnover of up to ₹5 crore to return GSTR-1 and GSTR-3B quarterly and pay tax monthly instead of return filing monthly. This was devised to lower the filing frequency of a number of MSMEs. CBIC and GSTN addressed various technical challenges that were hindering QRMP implementation in 2025, making it more reliable.

5.3 CBIC Registration Reforms (2025)

On April 2025, the Central Board of Indirect Taxes and Customs (CBIC) released guidelines to rationalize the procedure for registering under the Goods and Services Tax (GST). The Central Board of Indirect Taxes and Customs (CBIC) had issued guidelines to rationalize the process of registering under the Goods and Services Tax (GST) in April 2025 as per Union Budget 2025-26, which had made MSMEs the 'second engine of development'. Some of the key changes were that less paperwork was required in non-risky businesses, with a target turnaround time of seven working days; the reduction of physical verification requirements; and there was a pledge to more consistency between states in registration procedures. The reforms were particularly significant for proprietorship and partnerships, which were the most common forms of MSME organisations.

5.4 GST 2.0 and Rate Rationalisation

The 56th meeting of the GST Council on 3rd September 2025 marked a significant milestone in the evolution of the Indian GST regime, progressing towards the concept of 'GST 2.0'. The main rate change was to reduce the number of different rates from five (0%, 5%, 12%, 18%, 28%) to three (0%, 5%, 18%) and also to introduce a separate 40% rate for sin and ultra-luxury goods. This rationalisation came on the back of an existing concern among MSMEs on classification issues and the inverted duty structure.

In the era of GST 2.0, various goods and services that had earlier been in the 12% slab were moved to the 5% or 18% slab based on the nature of goods or services, which resulted in input cost reduction for several goods, intermediate

goods, packaging goods, and transport services which are extensively used by MSMEs. The thresholds for e-invoicing have been lowered, and pre-filled return has been extended to minimise manual input and data matching.

5.5 E-Commerce TCS Rate Reduction

In 2024, the GST Council had proposed a decrease in the rate of TCS applicable to e-commerce operators from 1% to 0.5%. This cut was aimed at alleviating the cash flow woes of MSMEs who depend on platforms like Flipkart, Amazon and Meesho for their business, as cash received by sellers is only available to them after TCS deductions are credited to them back in the system after they file their returns.

6. Remaining Simplification Needs and Policy Recommendations

Although there have been some of the above changes, a significant amount of simplification is still required. These recommendations are based on secondary data and stakeholder concerns outlined in parliamentary reports, industry body submissions and academic research.

6.1 Further Streamlining of Return Filing

The frequency and number of GST returns are still high compared to international standards. There should be a single periodic return system for the MSMEs with some correction mechanism, which does not send penal notices for minor errors committed. There should be just one periodic return system for MSMEs below the specified turnover limit with some built-in correction mechanism that does not lead to penal notices for minor errors committed. The existing legal penalties for minor errors are unfairly levied on MSMEs.

6.2 Adoption of Cash-Basis Accounting for Micro Enterprises

In sectors like semi-formal or cash-intensive micro enterprises it is very challenging to maintain the books of account as required under GST regime using accrual basis. Allowing cash-basis GST accounting for businesses with low turnover thresholds would make it more practical for the smallest businesses to comply, and would eliminate the need for professionals as an intermediary.

6.3 Expansion of Composition Scheme Benefits

The present restriction by the Composition Scheme on the ITC and inter-state supplies restricts it from being attractive for MSMEs with growth outlook. A modified scheme that enables limited ITC claims, such as capital goods and services, and a streamlined return-filing process would bring the scheme within the fold of a broader base of MSMEs, especially in the manufacturing segment.

6.4 Automated and Time-Bound Refund Processing

The slow processing of refunds is still one of the major issues faced by export-oriented MSMEs and the inverted duty structure. GST 2.0 promises automatic refunds; full implementation must be the top priority, the statutory deadline must be enforced, and interest must be paid for delays beyond the allowable period. Transparency and accountability can be achieved with a dedicated MSME refund portal or a dedicated track within the GSTN system.

6.5 Unique Business Identifier for Multi-State Operations

A unique business identifier (UBI) with a PAN number, similar to a centralised master account (CMA) for each MSME, as recommended by the Parliamentary Standing Committee (2025), would enable MSMEs to manage all their states' registrations from a single platform, thus eliminating duplicative registrations, administrative expenses and error-prone returns reporting across states.

6.6 Digital Inclusion and Capacity Building

To address the long-standing digital divide between advanced and lagging states, there is a need to invest in enhancing digital literacy and access for GSTN in rural and semi-urban regions. Sustained awareness and training programmes should be organised by the industry bodies, district industries centres and state governments focussed on the first generation entrepreneurs, women entrepreneurs and informal sector entrepreneurs who are shifting to the formal sector.

6.7 Stable and Predictable Tax Policy

Over time, there has been a cumulative effect of numerous GST changes that has led to an increasing compliance burden due to the constant reconfiguration of the system. The government should agree to a fixed rate plan for three years, or until their new rate plan is finalized and with full guidance material in advance of any rate plan changes. A stable tax policy eliminates uncertainty costs, and enables MSMEs to plan investments and pricing more effectively.

Table 3: Simplification Recommendations and Expected Outcomes

Recommendation	Addressess Challenge	Priority Level
Single periodic return for small MSMEs	Filing burden; penalty costs	High
Cash-basis accounting for micro enterprises	Digital & accounting capacity gaps	High
Expanded Composition Scheme with limited ITC	Working capital; ITC exclusion	Medium
Automated, time-bound refund processing	Refund delays; liquidity stress	High
Unique Business Identifier for multi-state MSMEs	Multi-state registration burden	Medium
Digital literacy and GSTN access programmes	Digital divide in lagging states	High
Stable 3-year rate structure commitment	Legislative volatility; planning uncertainty	Medium

7. Discussion

The information gathered in this paper indicates that there has been a persistent issue in the GST regime with regard to MSMEs. It has always been difficult for small businesses to adapt to the design logic of the system, which is based on large, formally structured and digitally capable enterprises, especially when they are constrained by a lack of resources, lack of formalism, and geographic disadvantage.

This tension is being increasingly recognized in policy and is reflected by the path taken from GST 1.0 to GST 2.0. All the measures taken towards rationalisation of rates, QRMP scheme, increasing the thresholds for Composition Scheme, streamlining registration process etc. are important measures towards MSME-friendly compliance design. The formalisation of MSMEs is a significant milestone, with an increase from around 5 lakh in 2017-18 to 1.5 crore by December 2024, yet the compliance framework must now accommodate a much larger and more diverse cohort of small businesses.

Formalisation should be done with care for the potential downsides of formalisation without simplification. What could happen is that the formalisation process could actually have a negative impact on the productive power of small businesses if they register for GST and then find that they have to absorb punitive compliance costs, delayed refunds, and notices on a regular basis. This risk is not speculative, but is indicated by the 60% of respondents who have seen an increase in operational costs, and the 65% who reported that there are significant compliance issues in their IJCRT (2025) survey.

The regional factor adds to the complexity. Several states, such as Tamil Nadu and Karnataka, have proven the feasibility of MSME-GST compliance integration with proper infrastructure and institutional support. With proper infrastructure and institutional support, states like Tamilnadu and Karnataka have shown that compliance integration between MSME and GST is feasible. The fact that only 40-50% compliance rates are observed in states such as Bihar, Jharkhand and Uttar Pradesh, however, shows that the national level policy cannot be sufficient to deal with structural gaps. Improved targeted, state-specific interventions, including digital infrastructure, capacity development and administrative support, continue to be vital.

8. Conclusion

India's original Goods and Services Tax (GST) design was a tough compliance burden for the MSME sector, exacerbated by structural hurdles like inadequate online access, resource limitations, multi-rate complexity, and the matching ITC-based invoice system, which is incompatible with the informal supply chain landscape. GST 2.0 is a massive shift back 9 years after the introduction, where rationalisation of rates, accounts for automation and streamlining of registration are making a difference in the right direction.

But the work is by no means done. GST will remain a burden rather than a blessing for MSME exporters as long as they do spend a part of their manpower on tax compliance, as long as they wait for the refunds to utilize working capital of the business, as long as they are disenfranchised systematically from the compliance ecosystem by digital exclusion in rural and semi-urban areas.

The recommendations contained in this paper (are not) costly and cumbersome to implement, nor are they radical overhauls of the system. They need specific reforms based on evidence and science that recognise the diversity of the Indian MSME ecosystem and consider the challenges of small business tax compliance. It is not just an issue of tax administration, but is a crucial issue in keeping India's quest to a \$5 trillion economy with small business thriving and inclusive growth in the economy.

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