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Informal Sector and GST Compliance: Social Protection and Labour Rights

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Abstract: The transition of the informal economy into formal frameworks is central to achieving sustainable growth and social justice under United Nations Sustainable Development Goal 8. While indirect tax reforms, notably the Goods and Services Tax (GST) introduced in India on July 1, 2017, have accelerated transactional tracking and expanded fiscal buoyancy, they have simultaneously imposed highly regressive compliance costs on under-resourced small enterprises. This paper investigates the phenomenon of "bounded formalization," wherein micro-enterprises adopt defensive survival strategies—such as strategic under-reporting and labor cost reduction to mitigate administrative overheads. Utilizing empirical survey metrics and macroeconomic data, this study demonstrates that tax enforcement absent integrated social protections has triggered severe labor market disruptions, including an estimated 15.7 million job losses concentrated in labor-intensive sectors. By analyzing Latin American "Monotax" models across Brazil, Argentina, Uruguay, and Mexico, this paper evaluates the viability of unified fiscal-welfare frameworks. The study concludes by proposing an integrated policy pathway for the Global South, emphasizing the administrative harmonization of tax databases with social registries, progressive labor taxation, and the expansion of non-contributory safety nets to secure a balanced transition toward decent work.

Keywords: Informal Economy, GST Compliance, Social Protection, Labour Rights, Economic Formalization, MSMEs, Bounded Formalization.

Introduction

The formalization of the informal economy has emerged as a core objective of contemporary international development policies, recognized globally as a prerequisite for achieving structural economic equity and sustainable macroeconomic growth. Historically, the informal sector has functioned as a massive employment sponge in developing economies, particularly across the Global South. However, this sector is structurally characterized by low productivity, an absence of legal recognitions, and severe deficits in decent work conditions. Globally, the policy imperative to formalize this ecosystem is heavily framed by the United Nations 2030 Agenda for Sustainable Development, specifically Sustainable Development Goal 8 (SDG 8), which obligates member states to promote sustained, inclusive economic growth, full productive employment, and decent work for all, with dedicated emphasis on migrant and highly vulnerable workers.

In recent years, governments have increasingly pivoted away from traditional, purely regulatory labor inspections, choosing instead to utilize sweeping indirect tax reforms to drive systemic economic formalization from the top down. Chief among these instruments is the Goods and Services Tax (GST). By establishing a continuous, technology-driven chain of input tax credits (ITCs), the macroeconomic architecture of GST forces an organic, cascading formalization across supply chains, effectively compelling informal operators to register or face commercial exclusion.

Despite its theoretical elegance as a tool for fiscal expansion, the practical implementation of GST reveals a profound and troubling tension between tax compliance and labor rights. While the state successfully deploys digital infrastructure to track transaction flows and secure revenue buoyancy, the structural realities of under-resourced micro, small, and medium enterprises (MSMEs) are frequently overlooked. Smaller firms bear a profoundly disproportionate administrative and financial burden relative to their revenue, a structural asymmetry known in tax literature as the "fixed cost" compliance problem.

When forced to operate within a rigid, data-matched tax regime without corresponding institutional support, these enterprises rarely transition fully into the formal economy. Instead, they enter a state of "bounded formalization," implementing defensive survival strategies that directly harm their workforce. To protect their razor-thin margins from escalating compliance costs and liquidity shocks, small enterprises routinely depress labor costs, reduce real wages, evade formal employment contracts, or exit the market entirely, displacing millions of vulnerable workers.

This paper critically assesses this dual frontier of economic formalization. It examines the structural mechanisms through which aggressive tax compliance cascades into labor market disruptions, details the phenomenon of bounded formalization among small enterprises, evaluates successful international policy counter-measures - specifically the integrated "Monotax" models of Latin America - and outlines a strategic, multidimensional policy framework designed to reconcile fiscal compliance with comprehensive social protection and labor rights.

2. The Macroeconomic Architecture of GST and Cascading Formalization

The deployment of the Goods and Services Tax (GST) as a primary lever for structural formalization represents a significant shift in fiscal policy design. The most prominent global manifestation of this approach occurred with the introduction of GST in India on July 1, 2017. This reform unified a highly fragmented and inefficient internal marketplace, consolidating a complex web of overlapping state and central levies - such as value-added tax (VAT), central excise duty, service tax, and entry taxes - into a single, comprehensive, destination-based ad valorem tax system. Operating under a concurrent constitutional tax list, the system enables both the Central and State governments to simultaneously levy taxes through three distinct channels: The State Goods and Services Tax (SGST), the Central Goods and Services Tax (CGST), and the Integrated Goods and Services Tax (IGST) for inter-state commerce.

The fundamental mechanism driving formalization through GST is its self-enforcing Input Tax Credit (ITC) infrastructure. Under an ITC framework, a business can offset the tax it owes on its output sales by the amount of tax it has already paid on its input purchases. However, this offset is strictly conditional: a business can only claim an ITC if its upstream suppliers have fully registered with the tax authority, uploaded their invoices in real-time, and accurately paid their respective taxes.

This digital cross-matching creates an immediate, systemic formalization cascade. Large, formal corporations at the top of the supply chain cannot afford to lose their ITCs, as doing so directly inflates their production costs and reduces market competitiveness. Consequently, these large entities place intense pressure on their informal, unregistered suppliers to formalize, register under the GST portal, and issue valid tax invoices. Informal firms face a stark, binary choice: formalize their operations to preserve their corporate B2B contracts, or remain informal and find themselves entirely excluded from major value chains. This architecture effectively shifts the burden of tax enforcement from the state's revenue department directly onto the commercial actors within the market itself, accelerating transactional transparency at an unprecedented scale.

3. Regressive Compliance Costs and the Mechanics of "Bounded Formalization"

While the structural architecture of GST has successfully accelerated the digitization and formalization of economic transactions, it has simultaneously imposed severe, regressive compliance burdens on small and micro-enterprises. During the initial rollout phases of India's GST, the regulatory architecture required

businesses to file three separate monthly returns (GSTR-1, GSTR-2, and GSTR-3), creating an administrative requirement of 37 separate filings per year. Although intense political and economic pressure eventually compelled authorities to simplify this framework into a quarterly filing system for smaller taxpayers, the absolute compliance load remains unsustainably high for enterprises operating on the margins of survival.

The fundamental policy flaw in executing a uniform, digitally native tax system across asymmetric economic actors lies in the regressive nature of compliance costs - frequently analyzed as the "fixed cost" problem in tax literature. The administrative overhead required to maintain digital accounting systems, hire professional assistance, reconcile mismatched invoices, and navigate shifting tax codes is largely static, regardless of the firm's size. Consequently, smaller firms bear a disproportionately larger administrative burden relative to their total revenue than their larger corporate counterparts. Empirical economic data highlights this severe distortion: micro-enterprises are forced to spend between 12% and 18% of their annual turnover purely on tax compliance, whereas large corporations, benefiting from economies of scale and dedicated legal-accounting departments, expend a mere 5% to 8% of their turnover on the same administrative tasks.

This stark imbalance is clearly reflected in empirical data capturing business perceptions of GST administration. The table below outlines the structural contradictions of the regime, illustrating that while high-level technical effectiveness is widely acknowledged, it is achieved at the direct expense of small-business sustainability:

These compliance challenges are severely compounded when analyzed across geographical and socio-economic divides. In semi-urban and rural areas, such as Rampur Bushahr, small business owners face acute structural barriers, including highly limited digital literacy, unstable IT infrastructure, erratic electrical grids, and a severe lack of localized awareness regarding complex, frequently amended GST regulations.

This severe capability-compliance mismatch prevents small operators from executing full legal formalization. Instead, it forces them into a suboptimal economic state defined as "bounded formalization". Rather than transitioning into fully visible, growing formal corporate entities, small firms adopt defensive survival strategies designed to minimize their exposure to the formal tax apparatus.

To remain safely below statutory tax turnover thresholds, an immense number of micro-enterprises engage in strategic under-reporting of sales, intentionally restrict their business expansion, and split single enterprises into multiple smaller parallel units. Furthermore, the technical friction of the GST network - specifically systemic delays in processing tax refunds and reconciling disputed ITCs - frequently triggers severe working capital shortages. Deprived of liquidity and lacking access to formal banking credit due to their ambiguous status, these small businesses are forced to rely on expensive, predatory informal credit networks just to cover daily operational gaps, trapping them in a cycle of financial vulnerability.

4. Labor Market Disruptions, Informality, and the Silos of Governance

The deep financial shocks and operational frictions induced by tax compliance extend far beyond balance sheets, actively reshaping labor market dynamics and worsening worker vulnerability. According to India's Periodic Labour Force Survey (PLFS 2024), approximately 83% of the total national workforce - amounting to roughly 390 million individuals - is informally employed. This massive pool of labor lacks legal protections and is highly vulnerable to macroeconomic volatility.

The aggressive enforcement of GST created an exceptionally hostile operational environment for cash-dependent micro-enterprises. Lacking the financial reserves or administrative capabilities to absorb these systemic shocks, under-resourced and unregistered informal units experienced a rapid 5.9% increase in business exit rates. These business failures translated directly into immediate, widespread job losses for informal workers. Empirical difference-in-differences economic analyses confirm that following the implementation of GST, informal employment fell sharply by 3.7 percentage points, resulting in an estimated 15.7 million job losses nationwide. These job losses were heavily concentrated in highly labour-intensive,

low-margin sectors; for instance, the textile sector experienced a 5.7% contraction in employment, while the retail trade sector contracted by 6.4%.

For the enterprises that managed to survive the tax transition, remaining cost-competitive under the new regime required immediate structural cost-cutting. Because small firms possess virtually zero pricing power over their inputs or tax obligations, they treat labor as their primary adjustable cost. Small businesses systematically cut labor expenditures by reducing real wages, extending working hours without compensation, or firing hired employees and replacing them with unpaid family labor. Consequently, the remaining informal workforce faces heightened precarity, characterized by irregular wage cycles, a total absence of written employment contracts, and zero access to healthcare, workplace safety guarantees, or pension schemes.

This labor crisis is exacerbated by fragmented government administration. Typically, the state's engagement with the informal sector is managed by completely separate departments operating in strict institutional silos, creating a notable regulatory gap where tax authorities aggressively enforce fiscal compliance while labor and social insurance departments remain completely unaware of these newly registered units. This leaves three distinct categories of vulnerable workers exposed to exploitation:

- **Unregistered Workers:** Employees whose working relationships remain completely undocumented, resulting in direct, continuous violations of both labor protections and tax codes.
- **Dependent Contractors:** Workers who are forced to sign commercial service contracts rather than formal employment agreements, yet remain entirely economically dependent on a single corporate entity that controls their hours, tools, and activities - a legally deceptive practice known as false self-employment.
- **Quasi-Formal Employees:** Workers who are officially employed within formally registered enterprises but are systematically excluded from social protection benefits, pensions, or medical insurance due to under-reporting of staff payrolls.

To analyze these complex labor market distortions, economists utilize the Formalization Tax Rate (FTR) and the Marginal Effective Tax Rate (METR). These metrics calculate the exact financial disincentives that occur when a worker or small firm attempts to transition from informal to formal status. The math governing this transition can be expressed through a basic relationship where the net benefit of formalization (B_f) is determined by subtracting the total formal tax liabilities (T) and mandatory social security contributions (S) from the worker's gross formal productivity (P_f), alongside any non-monetary regulatory compliance costs (C):

$$B_f = P_f - (T + S) - C$$

If the combined burden of formal taxes and mandatory social contributions exceeds the productivity benefits or wage premium of formal work, the FTR becomes prohibitively high. Under these conditions, low-wage earners and micro-entrepreneurs face a powerful financial incentive to remain entirely within the informal economy. However, empirical studies from developing countries demonstrate that introducing greater progressivity into labor taxation can effectively mitigate this problem. A highly progressive tax structure reduces the tax and contribution burden on low-income workers, lowering the FTR at lower wage levels, which encourages voluntary formalization while expanding the formal tax base without reducing overall government revenue.

When analyzed through the lens of the Multidimensional Poverty Index (MPI) framework developed by Alkire and Foster, the dangers of narrow, tax-centric formalization become clear. In the MPI framework, poverty reduction must account for both the headcount ratio of poverty (H) and the intensity of actual deprivation (A). Narrow formalization successfully addresses the administrative tracking of poverty (H) by placing workers into digital registration databases, but completely fails to reduce the intensity of actual deprivation (A). A registered worker who still lacks a living wage, safe working conditions, and social security remains deeply vulnerable to economic shocks. Furthermore, economic research indicates that focusing intense tax enforcement on registering large numbers of low-income micro-entrepreneurs is highly inefficient. This approach diverts scarce administrative and auditing resources away from investigating high-revenue tax

entities, while imposing regressive burdens on vulnerable populations.

5. Integrated Fiscal-Welfare Frameworks: The Global Monotax Model

To resolve the structural tensions between tax compliance and social protection, several forward-thinking countries—particularly across Latin America—have developed innovative, integrated policy frameworks known internationally as "Monotax" or Monotributo systems. These regimes simplify tax compliance while expanding social security coverage to self-employed workers, independent contractors, and micro-enterprises. Rather than treating taxation and social insurance as separate compliance burdens managed by uncoordinated ministries, the Monotax model combines them into a single, highly simplified, and subsidized periodic payment.

The table below outlines how different nations have tailored this integrated approach to fit their specific economic demographics:

Country	Integrated Tax-Welfare Regime	Target Population & Eligibility	Payment Structure & Subsidy Level	Core Social Security Benefits Provided
Brazil	SIMPLES / SIMEI	Micro-entrepreneurs (MEIs) and small business owners.	Flat monthly fee (~\$1 USD tax) + 5% of the national minimum wage for social security.	Full retirement pension, disability insurance, mandatory maternity leave, and access to public healthcare.
Argentina	Monotributo / Social Monotax	Own-account workers, small family units, and vulnerable informal traders.	Single flat-rate monthly fee (~\$23 USD). Subsidized up to 100% by the state for the lowest-income bracket via Social Monotax.	Comprehensive income tax waiver, VAT exemption, pension access, and entry into national healthcare programs.
Uruguay	Monotax / Social Monotax	Specific individual trades (artisans, gardeners, tutoring, sex workers) with strictly limited turnover.	Flat monthly fee (~\$50 USD) scaled progressively across presumptive income categories.	Full retirement pension, comprehensive maternity benefits, and healthcare coverage (excluding unemployment insurance).
Mexico	Régimen de	Small businesses	Ten-year gradual	Highly simplified

Country	Integrated Tax-Welfare Regime	Target Population & Eligibility	Payment Structure & Subsidy Level	Core Social Security Benefits Provided
	Incorporación Fiscal (RIF)	and retail units with an annual turnover under MXN 2 Million.	transition: 100% income tax discount in year one, decreasing by 10% annually over a decade.	digital invoicing via the "Mis Cuentas" portal and gradual, subsidized access to national social insurance.

These integrated regimes lower the structural barriers that prevent informal workers from participating in traditional, contributory social security systems. By combining tax liabilities and social insurance into a single, affordable, flat-rate payment, Monotax systems eliminate administrative complexity and align contribution requirements with the actual, volatile financial capacity of low-income informal operators. This approach has proven effective at expanding social security coverage, particularly among women and independent workers, significantly reducing the gender gap in social protection across Latin America.

However, the implementation of Monotax systems also introduces specific macroeconomic trade-offs that policymakers must carefully manage. Because the contribution rates for micro-enterprises are heavily subsidized to ensure affordability, these programs generate very little direct public revenue for the state. In Argentina, for example, the Monotributo system historically accounts for less than 0.2% of total public revenue collection. To remain financially viable, these programs require sustained, tax-funded subsidies drawn from general government budgets, leaving them vulnerable during periods of fiscal austerity. This structural vulnerability was demonstrated in late 2024. Following a series of federal budget cuts, the government dismantled the Social Monotributo subsidy and required low-income informal workers to pay 50% of their social security contributions out of pocket. Within weeks of this policy change, approximately 406,000 vulnerable workers dropped out of the system, losing their formal status along with access to healthcare and pensions. This case study highlights that without stable, long-term state fiscal support, simplified tax-welfare regimes can collapse, pushing vulnerable populations back into informality.

6. Strategic Pathways to Inclusive and Equitable Formalization

To build an inclusive and equitable formalization process, future policy design and economic research must be grounded in the structural realities of the Global South, where informal employment is often an economic necessity for survival rather than a choice to evade taxes. This requires a fundamental shift away from narrow, tax-centric formalization toward integrated policy frameworks that coordinate fiscal compliance with labor protections and social security. To achieve this transition, governments and international policymakers should consider five strategic reforms:

- 1. Harmonize Tax and Social Protection Databases:** Governments must dismantle administrative silos by integrating tax databases with national social security registries. For example, in the Indian context, this requires linking the Goods and Services Tax Network (GSTN) with the e-Shram national registry for unorganized workers. This digital coordination allows the state to utilize automated transaction tracking to identify and deliver targeted social benefits, ensuring that any firm entering the fiscal tax net is automatically registered to provide labor protections and social security benefits to its workforce.
- 2. Implement Transitional "Inclusion Bridges":** Following the successful structural designs

of Mexico's RIF and Argentina's Monotributo, states should establish transitional, simplified tax-and-contribution regimes for micro-enterprises. These "Inclusion Bridges" should feature progressive tax discounts that phase out over a decade, affordable flat-rate contributions, and free, simplified digital invoicing tools. This allows small businesses to gradually build administrative capacity without facing immediate liquidity crises or punitive compliance audits.

3. **Design Progressive Labor and Business Tax Structures:** To encourage voluntary compliance and registration, tax policies must incorporate progressive structures where contribution rates scale with the actual size, revenue, and productivity of the enterprise. Keeping tax rates low for low-productivity micro-units minimizes the Formalization Tax Rate (FTR), removing the financial disincentives that discourage informal operators from entering the formal economy.

4. **Strengthen Social Dialogue and Worker Representation:** Inclusive policy design requires the active participation of informal worker organizations, cooperatives, street vendor associations, and trade unions. Engaging these social partners ensures that formalization strategies address the practical needs and structural vulnerabilities of specific occupational groups—such as street vendors, handloom weavers, and agricultural migrant laborers—rather than imposing a rigid framework.

5. **Expand Non-Contributory Social Protection Floors:** For the lowest-income segments of the informal workforce, even heavily subsidized contributory Monotax systems may remain financially out of reach. Governments must complement simplified tax regimes with tax-financed, non-contributory social assistance floors. This ensures universal access to essential healthcare, occupational safety, and basic income security, decoupled from a worker's immediate tax status.

Ultimately, sustainable economic development requires a balanced approach to formalization. By linking the formalization of capital with the formalization of labor, states can ensure that tax compliance reforms do not marginalize vulnerable workers, but instead provide a pathway to decent work, comprehensive social protection, and equitable growth.

Conclusion

The formalization of the informal economy is essential for achieving inclusive economic growth, improved productivity, and decent work. However, the experience of GST-driven formalization demonstrates that tax compliance mechanisms alone cannot ensure equitable development. While GST has enhanced transparency, expanded the tax base, and encouraged business registration, it has also imposed significant compliance burdens on micro and small enterprises. These pressures have often resulted in bounded formalization, labor market disruptions, reduced wages, and increased worker vulnerability. Evidence from Latin American Monotax systems shows that formalization is more sustainable when taxation is integrated with social protection and labor welfare measures. Therefore, policymakers should adopt a holistic approach that combines simplified compliance systems, progressive taxation, social security coverage, and institutional coordination. By harmonizing fiscal reforms with worker protections, governments can transform formalization from a revenue-focused exercise into a pathway for social inclusion, decent work, and sustainable development in the Global South.

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