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"GST and India's Informal Economy: Evaluating the Transition from Unorganized to Formal Structures in Small Trade and Labour Markets"

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Abstract

The introduction of Goods and Services Tax (GST) in July 2017 represented a landmark indirect tax reform in India aimed at creating a unified national market and accelerating the formalization of the informal economy, which accounts for nearly 50% of GDP and employs over 80% of the workforce. This study examines the structural shifts triggered by GST in unorganized sectors, small traders, and informal labor markets, focusing on registration patterns, compliance burdens, supply-chain integration, and employment dynamics. Utilizing secondary data from GSTN reports, National Accounts Statistics, Periodic Labour Force Surveys, and empirical evidence drawn from difference-in-differences analysis of pre- and post-GST periods (2015–2025), the research reveals a process of "bounded formalization." While GST has expanded the tax base through input tax credit mechanisms—encouraging supply-chain formalization and enabling registered small enterprises to access formal credit and e-commerce markets—compliance costs (averaging 3–6% of turnover) have imposed a regressive burden on micro and small traders. Many informal units adopted coping strategies such as strategic non-registration, intermediaries, and selective digitalization, resulting in business closures and retrenchment of informal workers, with studies indicating a 3.7 percentage point decline in informal sector employment.In labor markets, GST-induced demand fluctuations have heightened job insecurity and wage pressures in unorganized segments, particularly

among migrant and daily-wage workers. Although overall tax revenue buoyancy and digitalization have improved, persistent challenges like administrative complexity and regional disparities continue to limit full integration. The findings underscore that GST has transformed rather than eliminated informality. Policy recommendations include simplified compliance frameworks, targeted capacity-building for MSMEs, faster refund mechanisms, and supportive digital infrastructure to achieve inclusive and sustainable formalization of India's informal economy.

Key Words: Goods and Services Tax (GST), Informal Economy ,Formalization, Unorganized Sector, Small Traders.

Introduction:

India's informal economy, comprising unorganized sectors, small traders, and informal labor markets, forms the backbone of the nation's economic structure. Accounting for approximately 45-50% of GDP and employing over 80% of the workforce, this sector has historically operated outside formal regulatory frameworks. The implementation of Goods and Services Tax (GST) on 1 July 2017 marked a pivotal shift towards unifying indirect taxation and promoting formalization. This paper assesses the structural transformations induced by GST in these segments, evaluating both intended benefits and unintended consequences up to 2025, including the recent GST 2.0 reforms.

Background of the Study:

Prior to GST, India's indirect tax regime was fragmented with multiple central and state levies such as excise duty, VAT, and service tax, leading to cascading effects and inefficiencies. The informal sector, dominated by micro and small enterprises (MSMEs) with turnover often below registration thresholds, thrived on low compliance but suffered from limited market access and credit. GST replaced this with a destination-based, value-added tax system designed to eliminate tax-on-tax and integrate supply chains.

Post-2017, GSTN data showed a surge in registrations, driven by input tax credit (ITC) incentives. However, the unorganized sector—encompassing street vendors, small retailers, handicrafts, and daily-wage labor—faced immediate disruptions. By 2025, NSO's Annual Survey of Unincorporated Sector Enterprises (ASUSE) reported 7.92 crore informal enterprises employing 12.8 crore workers, reflecting partial recovery after initial shocks from GST, demonetization, and the pandemic. Yet, structural shifts persist,

with formalization remaining "bounded" – partial and uneven across regions and firm sizes.

Importance and Relevance of the Topic:

The topic holds critical relevance amid India's ambition for a $5 trillion economy and inclusive growth. Formalization through GST enhances tax revenue buoyancy (monthly collections consistently exceeding ₹1.4 lakh crore since 2021-22), improves transparency, and integrates informal units into formal credit and digital ecosystems. For small traders and unorganized sectors, it offers supply-chain efficiencies and e-commerce opportunities.

However, regressive compliance burdens risk exacerbating inequality, job losses, and regional disparities, particularly in rural and semi-urban areas.

In the context of Sustainable Development Goals (SDGs) and Atmanirbhar Bharat, understanding these shifts is essential for policymakers to balance efficiency with equity. With informal labor markets vulnerable to wage pressures and insecurity, this study informs targeted interventions for MSMEs, which contribute 30% to GDP and 44% to exports. As GST 2.0 (2025) introduces simplified slabs and faster refunds, assessing long-term impacts ensures sustainable formalization without undermining livelihoods.

Review of Literature:

Summary of Previous Studies Related to the Research Topic:

Extensive literature documents GST's dual impact on India's informal economy. Early studies highlighted compliance challenges: Ghosh (2022) conducted a field survey of 157 MSMEs in Delhi, Mumbai, and Surat (2018-19), revealing 93% registration despite thresholds due to ITC and reverse charge mechanism (RCM) pressures.

Compliance costs averaged 3-6% of turnover, leading to 50% of firms retrenching workers (average employment drop from 20 to 16.6 per unit) and intensified labor exploitation in sectors like power looms and leather.

Shweta Shree B (2023) employed a difference-in-differences (DiD) approach using NSS Employment-Unemployment rounds, Annual Survey of Industries, and GSTN data (2015-2019). Results indicated a 3.7 percentage point decline in informal sector employment (15.7 million jobs lost), with higher impacts in retail trade (-6.4%) and textiles (-5.7%). Revenue from informal sources rose 24.3%, but compliance costs increased 6.7 percentage points, disproportionately affecting micro-enterprises. Exit rates rose 5.9%, concentrated among smallest units.

Recent analyses (2025-26) note partial recovery: NSO data shows informal enterprises grew 8% to 7.92 crore in 2025, adding 75 lakh jobs, with GVA up 10.87%. GST 2.0

reforms (simplified registration in 3 days, automated refunds) have eased burdens, boosting formalization via digital compliance.

Studies emphasize "bounded formalization" – transformation rather than elimination of informality – through coping strategies like intermediaries and selective digitalization. However, gaps remain in long-term labor market dynamics and post-2025 regional effects.

Research Gap:

While prior research captures short-term disruptions (2017-2022), limited empirical work examines structural shifts up to 2025, incorporating GST 2.0 simplifications and NSO 2025 data. Few studies integrate DiD with supply-chain and labor market analyses across unorganized sectors and small traders. Regional disparities and coping mechanisms in informal labor markets require deeper exploration. This paper addresses these by synthesizing secondary data for a holistic assessment of bounded formalization.

Objectives of the Study:

1. To analyze GST-induced registration patterns and compliance burdens in unorganized sectors and small traders.
2. To assess structural shifts in supply-chain integration and employment dynamics in informal labor markets.
3. To evaluate the extent of formalization versus persistent informality post-GST (2017-2025).
4. To identify policy gaps and recommend inclusive measures for sustainable integration.

Research Methodology:

Type of Study:

This is a descriptive and analytical study relying on secondary data to evaluate causal impacts and trends.

Data Sources:

Exclusively secondary sources for robustness and replicability:

1. GSTN reports and GST Council minutes (registrations, revenue).
2. Periodic Labour Force Survey (PLFS) and NSSO Employment-Unemployment rounds (2015-2025).
3. Annual Survey of Unincorporated Sector Enterprises (ASUSE) 2025 (NSO).
4. Economic Survey of India (various years) and MSME Annual Reports (2024-25).
5. Peer-reviewed studies using DiD and field surveys (e.g., Shweta Shree B 2023; Ghosh 2022).
6. National Accounts Statistics for GDP contributions.

Tools and Methods of Analysis:

Quantitative: Trend analysis, percentage changes, and synthesis of DiD estimates for pre/post-GST comparisons. Qualitative: Thematic review of coping strategies and policy documents. Data triangulated across sources for validity; no primary collection due to scope. Analysis conducted conceptually using Stata-like logic from referenced studies, focusing on 2015-2025 timeframe.

Data Analysis and Discussion:

GST expanded the tax base significantly, with over 2.5 million new registrations in FY25 (total active taxpayers rising steadily). ITC mechanisms cascaded formalization: B2B suppliers pressured informal units to register, enabling credit flows and market access. However, compliance costs remained regressive—3-6% of turnover for micro-traders versus lower for larger firms—leading to selective non-registration and intermediaries.

In unorganized sectors (e.g., textiles, retail, handicrafts), supply-chain integration improved for registered units, facilitating e-commerce and formal credit. Yet, DiD evidence shows early employment declines of 3.7 pp (15.7 million jobs), with retrenchment in labor-intensive areas. Small traders absorbed taxes or diversified to lower-slab goods, but inverted duties initially strained margins.

Informal labor markets faced wage pressures (-2.1% in some analyses) and job insecurity, especially among migrants. By 2025, NSO data indicates recovery: 75 lakh new informal jobs and 8% enterprise growth, aided by GST 2.0's simplified processes (e.g., 3-day registration, auto-populated returns). Digitalization enhanced revenue buoyancy but exposed digital divides. Regional disparities persist—stronger states saw higher formalization; weaker ones faced exits. Overall, GST transformed informality into "bounded" forms: partial integration with coping adaptations.

Findings / Results:

1. Bounded Formalization Achieved: 9.7% of informal enterprises registered post-GST, with ITC driving supply-chain shifts; yet 45-50% GDP informality persists.
2. Compliance Burden Regressive: Costs at 3-6% of turnover caused 5.9% higher exit rates and worker retrenchment (50% of surveyed MSMEs).
3. Employment Shifts:Initial 3.7 pp decline in informal jobs, but 2025 recovery added 75 lakh positions, indicating resilience.
4. Revenue and Efficiency Gains:Tax collections buoyant; digital tools reduced evasion but increased administrative load on small traders.
5. Labor Market Vulnerabilities: Heightened insecurity in unorganized segments; limited transition to formal social security.

Policy Suggestions / Recommendations:

1.Simplify Compliance: Extend quarterly/annual filing for micro-units (<₹40 lakh turnover) and expand composition scheme thresholds.

2.Targeted Support for MSMEs: Capacity-building via Udyam Assist Platform, subsidized accounting software, and faster ITC refunds (already improved in GST 2.0).

3.Sector-Specific Interventions: Skill programs and credit guarantees for high-impact sectors like textiles and retail; integrate informal labor with EPFO/ESIC.

4. Digital Inclusion:Subsidies for digital literacy and infrastructure in rural areas to reduce divides.

5.Monitoring and Evaluation: Annual NSO-GSTN linked surveys for tracking bounded formalization; state-level incentives for equitable outcomes.

These measures can convert GST's transformative potential into inclusive growth.

Conclusion:

GST has undeniably accelerated formalization of India's informal economy, fostering unified markets, revenue growth, and supply-chain efficiencies. However, structural shifts reveal a nuanced reality of "bounded formalization"—gains for larger/urban units alongside burdens on small traders and informal workers. Initial disruptions in employment and compliance have eased with recovery by 2025 and GST 2.0 reforms, yet full integration demands supportive policies. Achieving sustainable formalization requires balancing efficiency with equity, ensuring the unorganized sector's resilience contributes to India's economic vision. Future research should track long-term welfare impacts through longitudinal studies.

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