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GST and the Formalization of India's Informal Economy: A Review

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Abstract

India's Goods and Services Tax (GST), launched in 2017, represents a landmark reform in unifying indirect taxation while targeting the vast informal economy, which accounts for nearly 50% of GDP and 80-90% of employment. This review synthesizes empirical evidence on GST's role in formalization, highlighting incentives like input tax credits, digital tracking, and compliance drives. While revenue growth and tax base expansion are evident, challenges such as compliance burdens on micro-enterprises persist. Drawing from studies up to 2026, it assesses impacts, critiques limitations, and proposes inclusive strategies.

Keywords: GST, informal economy, formalization, tax compliance, MSMEs, India.

Introduction

India's economy has long been dualistic, with a formal sector coexisting alongside a dominant informal one comprising unregistered small businesses, street vendors, and casual labor. Pre-GST, a cascade of central and state taxes—excise, VAT, service tax—fostered evasion and inefficiencies, allowing informal units to undercut formal competitors. GST's introduction on July 1, 2017, aimed to create a seamless national market, curb tax evasion, and formalize the unorganized sector through technology-driven compliance.

This article reviews GST's mechanisms for formalization, empirical outcomes, sectoral variations, and policy evolution. It integrates findings from academic papers, government reports, and recent compliance initiatives as of March 2026, emphasizing

both successes and inequities.

Conceptual Framework: Informal Economy and Formalization

The informal economy evades regulation, taxation, and labor protections, yet drives growth in labor surplus contexts. Formalization involves registration, invoicing, and statutory adherence, yielding benefits like credit access and social security but imposing costs like paperwork and audits.

GST incentivizes this shift via:

1. **Input Tax Credit (ITC)**: Formal suppliers claim credits on purchases, pressuring informal chains to register.
2. **Digital Backbone**: GSTN portal, e-invoicing (mandatory for turnover >₹5 crore since 2023), and e-way bills enforce transparency.
3. **Thresholds**: Composition scheme for small units (turnover <₹1.5 crore) simplifies compliance.

Theoretical models, like those in All Finance Journal (2023), posit GST reduces "tax arbitrage" between formal-informal firms.

Empirical Evidence of Formalization Impacts:

Tax Base Expansion and Revenue Growth

Post-GST, unique taxpayers surged from 6.5 million (2016) to over 1.4 crore by 2025, with gross collections hitting ₹1.69 lakh crore in October 2025—a 7.1% YoY rise. Studies attribute 20-30% of this to informal sector onboarding, particularly via invoice matching.

A difference-in-differences analysis (2023) found GST boosted formalization by 12-15% among firms near thresholds. Digital payments (UPI transactions up 50% annually) further amplified this, linking cash economies to traceable trails.

Sectoral Shifts

Formalization varies by sector:

S **Sector**	**Pre-GST** **Informal Share**	**Post-GST** **Formalization Gain**	**Key Driver**
Textiles	70%	+18% registrations	E-way bills

Retail/Trade	85%	+10%	ITC chains
Construction	90%	+5-8%	Labor compliance
Food Services	95%	+12%	2025 drives

MSMEs in textiles saw accelerated shifts due to export incentives.

Employment and Productivity Effects

Formal jobs grew modestly (10% to 15-20% share), but short-term disruptions occurred: 15.7 million informal jobs lost (2017-19), mainly in trade and manufacturing. Productivity rose 5-7% in formalizing firms via better inputs.

Challenges and Critiques

Compliance and Exclusion Risks

Micro-enterprises (<₹20 lakh turnover) face high fixed costs: quarterly filings, tech access, and penalties. A 2023 survey revealed 40% of informal units cited "complexity" as a barrier. Digital divides exacerbate this in rural areas.

GST 2.0 (2025 reforms) intensified e-invoicing but marginalized low-literacy workers, risking a "two-tier" economy.

Economic Disruptions

Initial shocks hit labor-intensive sectors: leather exports fell 15%, with informal job losses. Unregistered suppliers lose ITC eligibility, inflating costs by 5-12%.

Adverse Impact	**Magnitude**	**Affected Groups**
Job Losses	3.7% employment drop (2017-19)	Casual laborers
Cost Escalation	+8% for small buyers	Street vendors
Evasion Persistence	20-30% informal trade	Cash-heavy niches

Government Initiatives and Recent Developments

The May 2025 pan-India drive, led by CBIC, targeted cash-intensive sectors using Sections

67 (inspections) and 24 (mandatory registration). Outcomes: 25% rise in voluntary registrations in pilot districts; focus on invoice mismatches and Aadhaar-GST linkage.

By 2026, GST-digital synergies (e.g., UPI-GSTN integration) have formalized 10-15% more units. Proposals include presumptive taxation extensions and MSME training.

Discussion: Balancing Formalization and Inclusivity

GST's success in revenue (24% CAGR) underscores formalization's fiscal gains, yet equity lags. Unlike demonetization's blunt shock, GST offers carrots (ITC) alongside sticks. Comparative studies (e.g., Sage Journals, 2022) affirm sustained formalization absent supports.

Future trajectories hinge on:

1. Tech subsidies for micro-units.
2. Labor transitions via skill programs.
3. State-specific thresholds.

Conclusion

GST has catalyzed informal economy formalization, evidenced by tax buoyancy and digital integration, though at transitional costs to the vulnerable. As India eyes Viksit Bharat by 2047, refining GST with pro-poor measures will ensure broad-based growth. Ongoing 2025-26 drives signal momentum, but empirical monitoring is vital.

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