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THE GST REVOLUTION: UNRAVELING ITS IMPACT ON INDIA'S SHADOW ECONOMY

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ABSTRACT

In 2017, the inception of the Goods and Services Tax ("GST") served as a turning point for the overall tax structure of India and transformed how companies in the informal economy interact with the tax system. This article considers how GST has influenced or potentially increased the degree to which the informal economy is becoming formalized, where traditionally, businesses in the informal sector have operated outside the view of revenue authorities. By reviewing a wide range of studies, theoretical frameworks, and empirical evidence, we consider the ways in which tax policy has driven business behaviour, the observable patterns of transition between sectors, and some of the ongoing challenges associated with this transition. The results indicate that performance is complex; while GST has been successful in encouraging some segments of the informal economy to register and comply with tax policy, there are still very real impediments to the success of the transition, primarily due to excessive administrative complexity, lack of adequate digital infrastructure, and the basic microeconomic characteristics of small-business operations. This review demonstrates the intertwining relationship between the tax reform process and the broader themes of economic development, strategic management of firms, and the different forms of entrepreneurship emerging in developing nations.

KEYWORDS: Goods And Services Tax, Informal Economy, Tax Compliance, Formalization, Economic Policy, Entrepreneurship, Organizational Change, India

INTRODUCTION

When you visit any market in India, like the busy streets of Udaipur, or the business districts of Bikaner, or in many areas of Rajasthan where goods are produced, you will see that the Indian Economy cannot be put into a simple category. For example, street vendors selling into a wholesale market; small manufacturers producing from tiny "home-based" facilities; and service sector workers working together with customer agreements rather than a legal contract; these are all part of the informal economy in India, which is estimated to account for approximately 90% of the total labour force and approximately 50% of the total GDP of India, but the vast majority operate outside formal taxation regimes (Chaplot, 2018).

The introduction of the Good and Services Tax (GST) in July 2017 was intended to change all this. GST replaced a collection of different tax systems operating at the Central and State levels with one combined tax system so that informal businesses would automatically have incentives to move into becoming formal businesses. This change has proven to be more complicated than the initial hopes for a seamless transition figure out how businesses will change their business model when faced with comprehensive tax changes rather than simply reviewing compliance numbers.

The Theoretical Landscape: Why Businesses Stay Informal

To fully understand the specific impacts GST will have, it is essential to understand why economies operate within an informal context. For example, conventional economic theory generally depicts informal economies as just being a vehicle for tax evasion. Yet this is a rather simplistic view particularly when one considers that millions of microenterprises exist and that many of these microenterprises are operating at subsistence-levels. Many of these microenterprises do not make a conscious decision to avoid taxes; rather, they are engaged in a complex process of decision-making designed to optimise their chances of surviving in a highly competitive environment.

In addition, the study of how organizations manage organization change (Mehta & Hiran, 2023) provides relevant information in this area, as the manner in which an organization reacts to an external issue (e.g., changing regulations, changes in the marketplace, or changes in technology) is highly dependent upon how effectively that organization is able to absorb and implement the changes into its business operations.

As smaller businesses that serve medium-sized metropolitan areas often lack the necessary infrastructure to effectively manage organizational changes, there is typically no HR department to oversee training and prepare employees for an impending change, and there is generally no legal team to interpret the tax circulars issued by government agencies, and in some cases, there may not be very much digital literacy among the employee base with respect to the online portals for compliance purposes.

From a strategic management perspective, the way that an entity aligns their operations with the demands of the environment plays a significant role in determining performance levels (Chaplot, 2018). However, aligning operations with environmental demands requires an investment of time, money, and knowledge resources, and informal businesses have little if any of these resources. The result is that there is a disconnect between the formal institutions established for larger and medium-sized businesses and the operations of the small businesses that operate with extremely narrow profit margins.

GST's Design and Initial Implementation

The goods and services tax (GST) established three tiers of registration that were intended to reflect the different sizes of businesses: (1) exemption from registering for turnover under INR20 lakh (INR10 lakh for special category states); (2) composition scheme for turnover up to INR1.5 crore; and (3) standard GST registration for larger enterprises. This tiered system represented an awareness of the diversity of India's economy; however, the actualisation of the GST produced difficulties due to the following factors:

An assumption was made that all businesses would have access to reliable internet service and a basic level of computer literacy so that they could submit their returns digitally; unfortunately, many businesses do not have adequate internet coverage or computer literacy. Furthermore, the requirement to submit monthly/quarterly returns presents a greater administrative burden on smaller businesses than on larger businesses.

The refinement of input tax credit provision is an excellent idea; however, it requires a considerable level of recordkeeping that most small businesses do not engage in.

The composition scheme was intended to be a simplified form of registration; however, by choosing to use the composition scheme, businesses may be at a disadvantage in competitive supply chains because buyers will be more likely to buy from registered businesses, as they

can take advantage of input tax credits passed through from their suppliers. This has created some rather strong, yet subtle, incentives for businesses to either seek full registration as a GST taxpayer or to remain informal.

Sectoral Variations in Formalization Patterns

Examples of diverse experiences with GST's formalisation pressures exist within various sectors - from which trends and dynamics of GST can be obtained. One such example is the tourism and hospitality industry studied by Choudhary and Madhwani (2013) during a time of economic uncertainty. As an industry that includes five-star hotels, small family-owned guest houses, and street vendors selling food, the methods of transitioning from informal to formalised GST compliance vary widely amongst those involved. Bikaner's family-owned guest house, for example, may have limited annual revenue that sits only marginally below the exemption threshold. Therefore, there are costs associated with formally registering for GST, while remaining informal increases the likelihood of losing customers who expect to receive a valid tax invoice.

The consumer goods sector represents another example of a sector subject to pressures to formalise related to GST. The research of Dave and Paliwal (2016) regarding how consumers perceive goods/supplies purchased in Udaipur illustrates that consumers assess various factors in addition to price when making purchasing decisions. As GST creates incentives for retailers to formalise their operations, consumers began to expect receipts and the transactions to comply with GST, even on routine day-to-day transactions with retailers. This increase in consumer expectations has resulted in market-driven pressure, which has proven to be more influential than regulatory requirements alone in encouraging businesses to transition to formal GST-compliant operations.

For example, digitizing and formalizing manufacturing supply chains shows the most dramatic effects of formalization pressures. When a major equipment manufacturer required its suppliers to submit proper VAT forms, many small component manufacturing companies were compelled to decide whether or not to formalise their operations or risk losing contracts. Although all these companies responded to the challenge of formalisation in the same way (i.e., they registered for VAT), they did not necessarily operate under formalised practices. A number of small manufacturers continued to operate as informal businesses, keeping very few records while doing most of their business "off the books."

The Revenue Composition Puzzle

Mehta's analysis of how the tax revenue composition can impact the fiscal effect of formalisation raises some interesting questions. The first thought may be that bringing informal businesses into the tax system will, on its own, support a larger number of people declaring more tax. However, evidence suggests that this is not necessarily the case, especially when considering the short- to mid-term. Many small businesses that have been recently formalised are generating minimal tax revenue, while at the same time consuming considerable amounts of administrative resources to monitor and enforce compliance.

This notion of small business formalisation aligns with evidence that confirms that the collection of taxes depends not only upon the number of registered entities, but also upon their actual turnover, profit margins, and quality of compliance. If a business registers solely for protection from penalties, and not a genuine desire to maximise its exposure to the formal economy, the revenue it contributes is likely to be minimal. The majority of the revenue collected from formalised businesses results from the formalisation of medium- and large-sized businesses, as formalising them allows for more accurate tracking of their economic activity through the supply chain.

Although it may appear that formalisation of small businesses is economically irrelevant, to disregard the benefits is to be very shortsighted. One potential benefit is that, in the long run, formalisation will improve access to credit for these businesses, provide better quality statistical data to be used for planning policies, and, through the gradual normalisation of tax compliance from successive generations of entrepreneurs, increase overall compliance rates. These benefits may take many years or even decades to fully be realised.

Digital Transformation and Consumer Behavior

The intersection of GST with digital commerce has created unexpected formalization pathways. Ahmed and Mehta's (2023) research on online purchasing behavior in home furnishing demonstrates how digital platforms inherently formalize transactions. When consumers buy furniture through e-commerce sites, the transaction automatically generates digital records, payment trails, and delivery documentation—making informal operation virtually impossible.

This digitalization extends beyond e-commerce to payment systems generally. The proliferation of UPI, digital wallets, and online banking has created transaction transparency

that supports GST enforcement. A street vendor accepting payments via QR code leaves digital footprints that earlier cash transactions never created. While this transparency brings benefits—reduced theft risk, easier accounting—it also removes the opacity that informality relied upon.

The role of artificial intelligence in consumer interactions, as explored by Abid and Yadav (2025), introduces another dimension. AI-driven customer relationship management, automated inventory systems, and algorithmic pricing all presume formalized business operations with structured data. As these technologies become standard even in small retail contexts, they create technical prerequisites for formality that complement GST's regulatory push.

Entrepreneurship in the Modern Context

The evolution of entrepreneurial businesses, including GST as it relates to assembly, proceeds along the continuum of the regulatory approach to business registration. The growing importance of digital technologies and internet-connected equipment and services as part of today's entrepreneurial landscape is increasingly reflective of the growing populations of entrepreneurs using these types of technologies to create new businesses. This trend is especially pervasive among younger generations of entrepreneurs who have received some type of post-secondary education. As such, these younger entrepreneurs tend to establish their businesses and register with GST at the time of business start-up, primarily due to alignment with their business plans.

It's essential not to overestimate the impact of this generational change on GST implementation. Most businesses will continue to be registered as traditional businesses (i.e., service providers, shopkeepers) in today's economy, with a strong majority being located in the regions of British Columbia, Alberta, Ontario, Quebec, and Nova Scotia. In contrast, the financial decisions pertaining to GST registration are made primarily by service-oriented or traditional entrepreneurs, such as shopkeepers and craftspeople, based on current financial conditions. Therefore, these types of entrepreneurs will not become "consumers" of formalization until immediate profits from their business can at minimum meet their family needs.

Persistent Challenges and Structural Barriers

Many years after the implementation of GST, large segments of informal economies remain in the same state as prior to GST. In order to understand the persistence of informal sector activity with regards to GST, it is important to look at barriers to formalization beyond the assumption of voluntarily choosing to not comply. Many of the obstacles to formalization are structural in nature rather than motivational.

For example, the administrative complexity created by the frequent changes made to GST through amendments, clarification and developments has created a constantly changing target for compliance that causes confusion for even professional tax advisors and provides additional complexity for small business owners. The fear of unintentionally violating a GST provision and incurring a penalty will cause some businesses to remain informal as the “cost” of remaining invisible is significantly less than the fear of consequences associated with an inadvertent violation.

In addition, there continues to be infrastructure limitations throughout much of India preventing businesses from being able to comply with GST. Many areas do not have consistent internet service; digital operations will frequently be interrupted due to electricity outages; and many businesses do not have access to computers or smart phones with the necessary software. These are not merely inconveniences, but are critical components of compliance under GST that many businesses do not have.

Finally, the question of economic viability remains a large obstacle to formalization for many businesses. For many, who operate on a subsistence basis, the direct costs associated with formalizing (e.g., compliance costs) and the indirect costs of formalizing (e.g., reduced flexibility, increased visibility) outweigh any possible benefits. Unless formalizing provides the opportunity for access to new markets, new forms of credit, or new customers who will pay higher prices than those available through informal sources, there is little economic incentive for formalizing.

Comparative Perspectives and Alternative Approaches

Examining how GST impacts other countries provides insight into how varying outcomes occur when implementing VAT-like taxes depending on the implementation specifics, enforcement capacity, and complementary policy provisions in each country. There have been some examples of successful results when tax reform has been combined with business

development services, the provision of simplified licensing programs, and improved access to formal credit; therefore, it is important to understand that, in order for businesses to become formalized, they must receive other forms of support beyond just tax policy. The work of Choudhary and Madhwani (2013) points to how the current recession has affected industries and how the broader economic situation affects an individual business's ability to become formalized; at times of strong economic growth, and when businesses are expanding, the costs of compliance with formalization are more easily absorbed by businesses as just another cost of doing business. At the time of a downturn, the same compliance costs can become a threat to businesses on the margin of formalization and push them back toward informality. Strategic management principles indicate that organisational transformation requires both external pressures as well as building the internal capacity of an organisation. This principle can be applied to the informal economy formalization; therefore, although tax policy is an important part of an organisation's ability to become formalized, it must be coupled with training in financial management, digital literacy programs, and simplified regulatory processes as well as, most importantly, demonstrating that there are visible benefits from compliance that will outweigh the costs associated with compliance.

Looking Forward: Policy Implications and Future Directions

So what has happened?

The implementation of the Goods and Services Tax (GST) has helped to formalise parts of the informal economy in India, especially within the industry chain and with those entrepreneurs using technology. However, a significant part of the informal economy still falls outside of the tax net and the imposition of formalising these businesses without addressing their obstacles will likely be a waste of time.

Going forward, in order to create a solid policy, we must recognize that all informal economies are not tax evasion cases, rather to find a way to formalise them effectively, as either an outcome of an economic condition or the result of regulatory complexity, or due to a lack of infrastructure to allow them to operate as formal businesses. To transition informal to formal businesses could involve various graduated methods of compliance based on business models, with very simple compliance measures for micro businesses; provide business support services along with business registration; use technology to eliminate additional burdens of compliance¹⁰⁹ and consider that the two (i.e. compliance and business support) are not mutually exclusive.

We know from experience that businesses successfully move from informal to formal status as the market and regulatory environment meets the needs of line of that business. For example, Consumer preference for invoice usage, supplier compliance for GST related vendors and banking requirement for vendor documentation provides incentives that are in addition to those through the tax policy. Promoting these market based mechanisms may be more effective than simply regulatory enforcement.

CONCLUSION

It is wrong to assume that GST's impact on the informal economy's transition to formalisation will be limited to an automatic transition as a result of better tax design (optimism) or the continuation of the mass experience of informalisation (pessimism). Rather, there are selective, uneven transitions to formalisation linked to economic factors, including sectoral industry dynamics (e.g. agriculture vs services), scale of operation (e.g. micro-scale vs large scale), regional infrastructure, generational factors and greater economic context.

This structure is still in transition. Digital infrastructure is being expanded, younger entrepreneurs are starting their businesses without following traditional norms, and GST is becoming stabilised through experience, so an increased number of entrepreneurs are likely to formalise in the future. Alternatively, if compliance is still viewed as being cumbersome and benefits are unclear, then going informal will remain the dominant operating mode for many small-scale businesses.

The consensus appears to be that tax policy alone cannot change the informal economy in India. Comprehensive support will be required to assist businesses with transitioning to formalisation, including a simplified process for registering businesses as well as developing digital infrastructure, providing business development services and providing clear economic benefits to those businesses that transition from informal to formalised operation. GST is certainly enabling the informal economy to be formalised; however, realizing that opportunity will require addressing the structural barriers that keep millions of small entrepreneurs in the shadows.

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