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Research Paper on Tax Policy Reforms and Their Effects on Small and Medium Enterprises in India

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ABSTRACT: Small and Medium Enterprises (SMEs) are the backbone of the Indian economy and contribute substantially to GDP, employment generation, and exports. Though the dynamic nature of tax policies is challenging and provides opportunities for such enterprises, the research paper assesses the effect of changes in tax policy reforms on SMEs in India in terms of growth, compliance, and competitiveness.

The government brought in a complete revolution in India through the introduction of Goods and Services Tax, better known as GST, with effect from 2017, which made replacing multiple indirect taxes one of the ways of simplifying the tax regime. While GST brought substantial compliance challenges to SMEs—be it the increase in documentation or the impetus for digitization—it, on the other hand, promises long-term efficiency in operations by way of simplification and with input tax credits. This paper explores these two sides of GST, including its comprehensive impact on the performance of SMEs, with particular highlighting of industry-specific challenges of the micro-enterprises and the agriculture SME sector.

It also discusses the potential role that income tax reforms—such as corporate tax rate reductions for small companies and presumptive taxation schemes—may play in relieving financial stress and promoting formalization. This study will also look into the interaction of tax policies with access to credit by SMEs, since most businesses depend on outside funding for expansions and survival. The paper debates the sequential impact of tax reforms on lender confidence in the creditworthiness of SMEs and their operational capabilities. In the merger of taxation with digital compliance tools, this is critically evaluated for long-run viability in the growth process.

This research identifies critical areas where tax policy reforms have had measurable effects on SMEs in terms of compliance costs, profitability, and competitiveness by using both qualitative and quantitative analyses. Simplification and reduction of taxes have contributed to an improved business environment; however, difficulties persist, especially for micro-enterprises lacking resources to cope with frequent policy changes. Besides, the role of digitalization in tax compliance turns out to be a double-edged sword: it empowers tech-savvy SMEs but marginalizes the less technologically inclined enterprises. This study will also look at the indirect impacts of tax reforms on employment trends and supply chain resilience within SME networks.

This research will also look into the regional disparities in the adoption of tax reforms and their differential impact on urban versus rural SMEs. The policy recommendations are provided to ensure that tax reforms underpin inclusive growth and offer a level playing field for all SMEs, irrespective of their size or location. These would comprise targeted financial incentives, simplification of the tax filing process, and increased access to various government support schemes. This paper critically reviews the current Indian tax policies and their implications. In that way, it adds to the ongoing discourse concerning creating a tax environment that will promote SME resilience and growth in tandem with the broader national economic priorities.

KEYWORDS: Tax Reforms, SMEs, GST, Compliance, Corporate Tax, Digitalization, Economic Growth, India, Financial Inclusion.



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I. INTRODUCTION

Small and medium enterprises form the backbone of India's economy, with substantial contribution to employment generation, industrial output, and exports. With a contribution of more than 30% to India's GDP and around 45% of the total manufacturing output, S&M enterprises in India are important drivers of economic growth and equitable development. The regulatory framework is often dynamic, and tax policies always have very significant implications for growth, competitiveness, and sustainability in these enterprises. That which makes the study of tax policy reforms in the context of SMEs very imperative is the peculiar challenges that most SMEs face in accessing capital, being very vulnerable to economic shocks, and compliance burdens.

In the recent past, tax policies in India have been significantly reformed, particularly through the landmark measure of streamlining indirect taxation with the implementation of the Goods and Services Tax (GST) in 2017. GST has come in place of the complex web of central and state taxes with a unified tax structure, in hopes of bringing compliance costs down, and improving ease of doing business. While reforms have been generally lauded to simplify taxation, it also opened up several challenges for SMEs, mainly due to the lack of both technological readiness and financial resources to adapt into the new regime. Also, direct tax reforms have been kick-started: amendments in corporate tax rates, presumptive taxation schemes, and tax incentives for start-ups, in order to give relief to the smaller businesses and enhance their operational efficiency.

These notwithstanding, the effectiveness of the reforms in the area of tax policy on the peculiar needs of SMEs is an issue open to debate. Empirical evidence suggests mixed results, wherein some of the enterprises benefit from reduced compliance costs and a level playing field, while others suffer from increased compliance demands and disruptions in cash flow. Moreover, variations in tax policy implementation across regions further exacerbate the challenges that the SMEs face, mostly in rural and semi-urban areas.

Another important dimension is the role of digitalization in tax compliance, notably e- invoicing and online filing systems, together with the digitization of tax-related processes, all designed to increase transparency and cut costs. These, however, normally come with substantial investment costs in acquiring relevant technology and training, costs that for many SMEs are intimidating. The way such reforms either support or hamper SME growth depends on a variety of factors, such as the size of the firm, sectoral characteristics, and geography.

The present paper tries to analyze the impact of tax policy reforms on SMEs in India with regard to their business performance, compliance behavior, and growth potential. This would try to fill the literature gap by focusing on the dual aspects of tax reforms: benefits and challenges, exploring policy recommendations to enhance SME competitiveness. The interrelation of fiscal policies with other broader economic aspects, such as access to finance, market dynamics, and technological advancement, is also given focus in the study.

II. OBJECTIVE

1. Impact Evaluation of Tax Reforms on SME Growth and Financial Stability

A detailed analysis of the impact of significant changes in tax policies, such as GST and corporate tax reduction, on profitability, investment, and expansion for SMEs in India.

2. Tax Compliance Costs and Operational Challenges for SMEs: Analysis

An in-depth analysis of the tax compliance burden on SMEs in terms of the cost of administrative compliance, adoption of technologies, and navigational complexities.

3. Exploring Sectoral and Regional Disparities in Tax Policy Implementation

Analyze how the SME tax reforms vary across the industries and geographies: urban, semi-urban, and rural.

4. Tax Administration and SMEs: An Evaluation of Contribution by Digitalization

Evaluate the impacts arising from digital tax compliance solutions in e-invoicing and online filing on efficiency in SME operations, simplicity, and transparency for tax filing.



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III. REVIEW OF LITERATURE

1. Impact of Goods and Services Tax (GST) on SMEs in India

The introduction of GST in 2017 brought about a drastic change in the tax structure of India by integrating all indirect taxes. Several studies indicate that while GST streamlined the tax regime, it was SMEs that bore the brunt of the compliances due to resource constraints and technological incompatibility. According to research, the operational cost increased for SMEs during the initial implementation phase but, over time, the advantage of process efficiency and input tax credits gained more prominence.¹

2. Corporate Tax Reforms and SME Profitability

The recent corporate tax rate cuts were enacted to promote economic growth by increasing the profitability of businesses, including SMEs. Empirical studies have found that lower tax rates have resulted in more business reinvestment, which promotes expansion and innovation among SMEs. However, the benefits are spread unevenly across sectors, with SMEs in manufacturing showing more significant gains compared to service-oriented SMEs.²

3. Compliance Challenges Post-Tax Reforms

Most tax reforms introduce new compliance requirements, which can be highly demanding for SMEs with limited administrative capacities. Much research underlines that the majority of SMEs find it difficult to understand and implement new tax provisions, which increases their reliance on external consultants and raises compliance costs. This situation calls for special support and a simplification of procedures to facilitate the transition for SMEs.³

4. Regional Disparities in the Impact of Tax Reforms

The effects of tax reforms are not uniform across India; some studies have found considerable regional disparities. According to some, SMEs in urban areas coped more easily with changes because of better infrastructure and access to information. Those in rural areas faced barriers in the form of lack of digital connectivity, inadequate professional advice, or both, in complying with new tax regulations.⁴

5. Sectoral Analysis of Tax Reform Impacts

Different sectors experience varying impacts from tax reforms. For instance, the manufacturing sector has benefited from input tax credits under GST, reducing the overall tax burden. Conversely, service sector SMEs have faced challenges due to the broadening of the tax base and increased tax rates on certain services. Sector-specific studies emphasize the need for nuanced policy approaches to address these disparities.⁵

6. Digitalization and Tax Compliance

While digital tax compliance mechanisms, such as e-invoicing and online return filing, are the push toward increased transparency and efficiency, research proves that the majority of SMEs lack the requisite infrastructure and skills—a huge impediment to compliance. The only bridging initiatives can be in the area of increasing digital literacy and the availability of affordable technological solutions.⁶

7. Effectiveness of Tax Incentives for SMEs

Many governments also provide tax incentives to encourage SME growth. Research evaluating such measures often presents mixed results. While some SMEs have utilized the incentives in the form of tax holidays and reduced rates to invest in expansion, others are unaware or cannot meet the eligibility criteria—thereby limiting the effectiveness of such policies.⁷

8. Long-Term Sustainability Post-Tax Reforms

Assessing the long-term sustainability of SMEs in the post-tax reform era, some researchers show that although there were initial strong disruptions, many SMEs have coped with the new tax environment. This evidences that continuous learning and adaptation have been a very significant determinant for their resilience and continued growth.⁸

9. Access to Finance and Tax Policy Reforms

Tax policies may also affect access to finance by SMEs. Studies have shown that a clear and stable tax regime is associated with increased confidence of financial institutions in extending credit to SMEs, while frequent changes in, or complex, tax structures may be seen as deterrents to lending.⁹



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10. Informal Sector and Tax Reforms

A large part of India's SME landscape operates in the informal sector. Evidence suggests that tax reforms aimed at broadening the tax base have encouraged formalization. However, moving from informal to formal status implies increased compliance costs and exposure to regulatory scrutiny, which some SMEs are unwilling to pursue.¹⁰

IV. RESEARCH METHODOLOGY

1. Research Design:

- Research type – The type of research that we opted for in this particular case is qualitative. This is because most of the entirety of the research consists of the reasoning for the way in which the tax policy reforms impact on the SMEs. Therefore our research has minimum to no weightage on numerical and encompasses strong reasonings and facts which determine and support the mentioned causes that take place on the Small and Medium enterprises on the basis of these tax reforms.
- Purpose – It is an exploratory and explanatory to assess how tax reforms influence the performance and sustainability of Small and Medium Enterprises.
- Approach – It is a completely descriptive and analytical approach as it describes in theory and in depth as to how the changes in tax policy reforms affect the operations capability and burdening on the said SMEs.

2. Data Collection:

Secondary Data – The data that we have used in our report includes second hand data collected from other sources so that we could analyze the said data and form a conclusion on the topic. After analyzing the data from the various sources, we formed interpretations on the same. These include:

- Government reports, policies, and tax reform documents.
- Statistical data from SME associations and chambers of commerce.
- Published research papers, journals, and case studies on tax policies and SMEs

3. Analysis Technique:

- The analysis technique was done through MS Excel with help of filtration method using keywords. Further that the articles which were collected was evaluated, and the relevant content that was needed was used for referencing. This helped us in quick collection of data in a short period of time.

4. Justification for our methodological choice:

- Cost and Time Efficiency - It saves on cost and time since it has already been collected. Also, it is more time and cost-effective compared to collecting primary data.
- Large Sample Sizes: These datasets often consist of huge samples, like national surveys, which may be impossible to reproduce independently.
- Longitudinal Analysis. One of the advantages of using secondary data is that it can access historical or even long-term data and allows a researcher to look at trends over time.

V. DATA ANALYSIS: IMPACT OF MSMES ON THE INDIAN ECONOMY

1. Contribution to GDP

The share of MSME Gross Value Added (GVA) in India's Gross Domestic Product (GDP) has experienced fluctuations:

-2019-20:30.48%

-2020-21:27.24%

- 2021-22: 29.15%

This decline in 2020-21 can be attributed to the economic disruptions caused by the COVID-19 pandemic, with a subsequent recovery in 2021-22.



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2. Manufacturing Sector Contribution

MSMEs have maintained a significant share in the manufacturing sector's GVA:

- 2019-20:40.67%
- 2020-21:40.30%
- 2021-22: 40.83%

These figures indicate a stable contribution of MSMEs to India's manufacturing output.

3. Export Performance

The percentage share of MSME-related products in India's total exports has seen a gradual decline:

- 2019-20:49.77%
- 2020-21:49.35%
- 2021-22:45.03%
- 2022-23:43.59%
- 2023-24 (up to September 2023): 45.56%

The dip during 2020-21 and 2021-22 may be linked to global trade challenges during the pandemic, with signs of recovery in 2023-24.

4. Employment Generation

As of December 6, 2023, the Udyam Registration Portal recorded total employment of 15.50 crore individuals in the MSME sector since its inception on July 1, 2020.

5. Credit Gap

An Expert Committee constituted by the Reserve Bank of India in December 2018 estimated the overall credit gap in the MSME sector to be between ₹20 to ₹25 trillion.

VI. GOVERNMENT INITIATIVES

To address these challenges and support MSMEs, the government has implemented various measures:

- Prime Minister's Employment Generation Programme (PMEGP): A credit-linked subsidy program aimed at generating self-employment.
- Pradhan Mantri Mudra Yojana (PMMY): Provides loans up to ₹10 lakh to non-corporate, non-farm micro/small enterprises.
- Credit Guarantee Scheme: Facilitates collateral-free credit up to ₹5 crore to Micro and Small Enterprises.
- Self-Reliant India (SRI) Fund: An equity infusion of ₹50,000 crore.
- Udyam Assist Platform: Launched on January 11, 2023, to bring Informal Micro Enterprises under the formal MSME sector.
- Inclusion of Retail and Wholesale Traders: Recognized as MSMEs for Priority Sector Lending benefits since July 2, 2021.
- Trade Receivable Discounting System (TReDS): Facilitates financing of trade receivables of MSMEs from corporate and other buyers, including government departments and PSUs.
- Emergency Credit Line Guarantee Scheme (ECLGS): A ₹5 lakh crore scheme for businesses, including MSMEs, operational until March 31, 2023.

These initiatives aim to enhance financial accessibility, support employment generation, and promote the overall growth of MSMEs in India.



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VII. RESULT

Key Findings from Data Analysis:

1. Contribution of MSMEs to GDP:

- MSME Gross Value Added (GVA) as a percentage of GDP was as follows:
 - 2019-20: 30.48%
 - 2020-21: 27.24% declined due to COVID-19
 - 2021-22: 29.15% recovery

2. Manufacturing Sector Contribution:

- MSMEs have been contributing about 40% of India's manufacturing output continuously over the years, which is stable despite the economic shocks.

3. Export Performance of MSMEs:

- The share of MSME-related exports has been declining:
 - 2019-20: 49.77%
 - 2020-21: 49.35%
 - 2021-22: 45.03%
 - 2022-23: 43.59%
 - 2023-24 (up to Sep 2023): 45.56%
- The contraction in 2020-21 and 2021-22 was due to pandemic-induced global trade issues.

4. Employment Generation:

- As on 6th December 2023, 15.50 crore persons were employed in the MSME sector (as per Udyam Registration Portal).

5. Credit Gap in MSMEs:

- Estimated credit gap of ₹20-25 trillion, as per an RBI Expert Committee (2018), indicating financial constraints.

VIII. IMPACT OF TAX REFORMS ON SMES

1. GST Implementation:

- Positive Impact: Simplified tax structure, input tax credits, reduced cascading taxes.
- Challenges: High compliance burden, digital literacy issues, cash flow disruptions for micro-enterprises.

2. Corporate Tax Reforms:

- Lower tax rates have increased SME profitability, especially in manufacturing.
- Service-sector SMEs have faced higher tax burdens under GST.

3. Digitalization and Compliance:

- E-invoicing and online returns have increased efficiency but pose a challenge for less tech-savvy SMEs.
- Infrastructure constraints hold back rural SMEs in adopting digitization and are falling behind.

4. Regional and Sectoral Disparities:

- Urban SMEs adjusted more easily to the new tax regime due to better infrastructure.
- Rural SMEs are finding compliance hard with a lack of digital resources.

5. Government Initiatives to Support SMEs:

- PMEGP: A credit-linked subsidy for self-employment
- PMMY: Up to ₹10 lakh loan to micro-enterprises



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- Credit Guarantee Scheme: Collateral-free loans up to ₹5 crore.
- Trade Receivable Discounting System (TReDS): Assist SMEs with trade receivables
- Emergency Credit Line Guarantee Scheme (ECLGS): ₹5 lakh crore credit support.

IX. CONCLUSION

The changes in the Tax policies have had a significant influence on the ecosystem of Small and Medium Enterprise in India with its repercussions being both positive and challenging. The Government intended to bring simplicity to the tax regime and a unified structure of taxation through the introduction of the Goods and Services Tax in 2017 to increase efficiency in doing business. However, the transition has been painful for many SMEs, especially micro-enterprises and those located in rural areas, due to the high costs of compliance, problems related to digital literacy, and increased documentation.

This reduction in corporate tax rates has provided some relief to SMEs, and the increased profitability is being reinvested in business expansion. However, this benefit is not uniform across all sectors. SMEs in the manufacturing sector have benefited more than service-sector enterprises, which had to bear higher tax burdens under the GST regime. Digitalization of tax compliance, including e-invoicing and online tax filing, has brought transparency and operational efficiency to technologically savvy SMEs. However, the digital divide is a critical concern, as many small businesses do not have the infrastructure and expertise needed to fully benefit from these developments. Urban SMEs, able to adapt more easily because of better connectivity and resources, are in a position to be able to deal with the requirements of changing tax regulations, whereas rural enterprises struggle.

Despite the steps of the tax reforms, access to finance remains one of the major constraints for SMEs, with an estimated credit gap of ₹20-25 trillion. To address this, the government has floated several schemes: the Credit Guarantee Scheme, the Emergency Credit Line Guarantee Scheme (ECLGS), and Pradhan Mantri Mudra Yojana (PMMY). All these schemes need to be continuously reviewed for their outreach and impact.

Furthermore, tax compliance and the implementation of policies bring about regional disparities that further complicate the growth trajectory of SMEs. Business enterprises located in urban areas have been better placed in dealing with tax reforms; on the other hand, difficulties in semi-urban and rural areas in adapting to regulatory changes persist.

In the future, policy prescriptions should address reducing SMEs' compliance burdens, increasing digital literacy, and extending financial support mechanisms. Other things that would go a long way in creating an enabling economic environment for SMEs include simplifying tax filing procedures, using targeted incentives for micro-enterprises, and ensuring regional inclusivity in tax administration. With these challenges duly addressed, tax reforms can provide the impetus for growth, financial inclusion, and resilience in the SME sector to increase in step with broader national economic priorities.

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