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TAX POLICY EVOLUTION FOR MSMEs AND SMALL-SCALE INDUSTRIES IN INDIA: FROM POST-INDEPENDENCE TO THE GST ERA

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ABSTRACT **DOI No: 10.36713/epra27998** **Article DOI: https://doi.org/10.36713/epra27998**

This article examines the evolution of tax systems in the post-independence period, with special reference to the Micro, Small and Medium Enterprises and their predecessor, the Small-Scale Industries, until the introduction of the Goods and Services Tax in 2017. The study was a systematic review of legislative provisions, plan documents, and scholarly literature to determine the impacts of direct and indirect tax legislation on small producers over the last seven decades. Understanding the benefits enjoyed by small firms at each phase of taxation, along with the burden imposed on small firms by the tax systems. The article concludes that Indian taxation policies for small industries are shaped by protective measures for labour-intensive small enterprises, and that these policies struggle to bring them into the formal economy. GST was able to solve some of the old problems, but the increased compliance burden of GST was a hurdle for the MSMEs

KEYWORDS: ***MSMEs; Small-Scale Industries; Indirect Taxation; GST; VAT; Tax Policy; Informality; India***
JEL Classification: H25, H26, H71, L53, O17

1. INTRODUCTION

The Micro, Small, and Medium Enterprise sector holds a significant place in the Indian economy by contributing approximately 30 per cent of GDP, employing over 110 million people, and accounting for nearly 45 per cent of India's total exports. MSMEs and their predecessor, the Small-Scale Industry, are not a marginal part of the economy; it's the strength of the economy (Ministry of MSME, 2021; Tendulkar & Bhavani, 2007). This sector was governed and taxed by complex mechanisms in the post-independence era of the country.

Taxing the MSMEs/ SSIs was a challenging exercise due to their limited record-keeping and low compliance behaviour. Exempting them from the entire taxation mechanism by the state will lead to loss of a considerable revenue from the sector, which accommodates a large part of the employment in the country, and sometimes lead to distortion in the industrial structure. In the post-independence period policymakers tried to address the taxation of MSMEs through various tax mechanisms along with provisions like exemptions and reservations under the Central Excise regime, Modified Value Added Tax (MODVAT), the Central Value Added Tax (CENVAT), state-level VAT (Bagchi, 2005; Chelliah, 1991), and finally the unified Goods and Services Tax.

With this article, an attempt has been made to capture the taxation mechanism of MSMEs/SSIs in the post-independence period by analysing the important benefits and drawbacks of the taxation system on MSMEs/SSIs, along with a small comparison of the Goods and Services Tax with its adjacent predecessor, the State-level Value Added Tax Mechanism. The article was concluded with reflections on the seven decades of taxation of MSMEs.

2. THE FOUNDATIONS OF POST-INDEPENDENCE INDIRECT TAXATION: CENTRAL EXCISE AND SSI EXEMPTIONS (1947–1965)

2.1 Legislative and Policy Context

In the initial phase of independence, the Central Excises and Salt Act, 1944, from the colonial period was primarily used to raise indirect taxes mostly from the large-scale manufacturing firms and the Income Tax Act of 1922 was used for governing the direct taxation. At that juncture, no specific taxing mechanism was adopted for small-scale enterprises (Chelliah, 1991). The Industrial Policy Resolution of 1948 and 1956 proposed a separate industrial structure in the country. One is the large-scale manufacturing dominantly controlled by the public sector and the labour- intensive small-scale sector protected through reservations and concessions. (Government of India, 1956; Frankel, 2005).

The second five-year plan (1956–61) explicitly treated fiscal concessions for the small-scale sector as an indirect subsidy for

the employment and equity concerns delivered by the sector (Planning Commission, 1956). Tax exemptions are treated as development instruments, and this ideology remained powerful in the initial decades of independence.

2.2 Benefits for the SSI Sector

Small-scale enterprises falling below a specific threshold in terms of output were fully exempted from the central excise duty, and those above the threshold and below a prescribed ceiling will attract concessional rates. This created a three-tier structure in taxation: exempt, concessional and fully liable (Ahluwalia, 1985).

On the direct tax side, proprietorships and partnerships, mainly the small-scale sector, are treated as individuals rather than companies, kept them in the lower slabs of income tax and insulated from the comparatively higher corporate tax rates (Rao & Singh, 2006). Depreciation allowances and investment allowances benefited capital-scarce small firms making initial machinery investments (Bagchi & Stern, 1994).

2.3 Burdens and Drawbacks

The Central Excise tax of this period was heavily burdensome for the firms above the exemption threshold. The tariff was specific rather than ad valorem for many categories, which means that small producers in excisable industries faced heavy tax liabilities irrespective of profitability (Purohit, 2006). The cascading effect in the excise penalised the firms without credit for taxes paid on inputs, which meant that tax accumulated through the production chain will increase the burden of small firms with larger value chains and inter-firm transactions (Kumar, 1994) which led to increased price of SSI products.

Apart from this, a major structural hurdle was linked with this era, the rigid exemption threshold motivated the firms to remain small or to split the production by nominally separated units, suppressed output and resisted managerial consolidation to preserve the exemption. Hsieh and Olken (2014) later analysed that the clustering of firms below the threshold as the reason for the missing middle, the absence of medium enterprises in the Indian economy. The reservation policy also curtailed the firms from entering into the areas reserved for the SSIs, which also incentivises the firm to stay below the threshold (Mohan, 2002).

2.4 System Assessment

In this period, the excise framework was a success in terms of generating employment and new small entrepreneurs. But the fiscal angle was not up to the mark, the unscientific exemptions led to a shadow economy, limited tax compliance in the informal sector and cascading of taxes made the system inefficient. (Joshi & Little, 1994). The system protected small industries but did not provide incentives for their growth.

3. INDUSTRIAL REGULATION AND FISCAL COMPLEXITY DURING THE LICENSE RAJ (1965–1984)

3.1 Policy Context

In the period of license raj, the regulatory framework became highly government-invasive. The industrial licensing policy inquiry committee, headed by Subimal Dutt, found the extreme concentration of industrial power in large firms and recommended the strengthening of SSIs through reservations (Government of India, 1969). As a result, the number of items in the reservation list exceeded 800 items. The list of products reserved for small-scale manufacture eventually created a regulatory wall around the SSIs and reshaped the fiscal environment (Mohan, 2002). Simultaneously, the income tax was pushed; the marginal rate of income tax and surcharge combined reached 97.5 per cent in 1971–72 (Panagariya, 2008).

3.2 Benefits for the SSI Sector

The combination of exemptions and reservations, along with higher income tax rates, reduced the direct competition from large enterprises. Because large companies had faced a higher tax burden with strict license requirements, SSIs enjoyed the reservations and exemptions. Periodically, the exemption threshold was revised upwards, expanding the number of formally exempted enterprises (Ahluwalia, 1985). Sales tax concessions and deferral schemes by the state governments also extended the tax benefits of SSIs (Rao & Singh, 2006). The partial introduction of the MODVAT system in 1986 also offered a limited relief from the cascading problem, and the tax credit claim allowed on specified inputs also reduced the effective tax rate to a limited extent (Chelliah, 1991).

3.3 Burdens and Drawbacks

The tariff schedule of the excise duty system was expanded to thousands of product classifications with varying rates, making the system more complex in the early 1980s (Purohit, 2006). For SSIs with limited accounting expertise and legal awareness, these complications became more burdensome. The poor administration of the MODVAT system, introduced with improper exclusions, made the system inefficient and inaccessible to SSI firms (Bagchi & Stern, 1994).

The heavy income tax rates kept a large part of the SSI sector in the informal economy. 20-30 per cent of the economy was informal, composed of small businesses evading both direct and indirect taxes (Bhattacharyya 1990). Informality was not merely a tax avoidance strategy but became structurally rooted, preventing small firms from accessing formal credit, insurance, and government procurement markets.

The sales tax system adopted at the state level was an addition to the burden for small firms operating in interstate trade through different rates for the same products in different states. And a correction mechanism introduced as the Central Sales Tax (CST), without input credit, imposed an additional burden on the small firms going beyond the state borders for sourcing raw materials and other inputs. (Bird & Gendron, 2007).

3.4 System Assessment

In the period between 1965 and 1984, the combination of cascading excise duty, high rates of income tax, and state-level sales taxes made the fiscal scenario uneasy for the SSIs. The extremely small firms that are enjoying the reservation and tax exemptions are not incentivised to grow bigger, and are kept small all the time. Even though the fiscal failures were recognised earlier, they were not properly taken care of until the crisis of 1991 (Joshi & Little, 1994).

4. LIBERALISATION, TAX REFORM, AND THE CHANGING FISCAL ENVIRONMENT FOR SSIS/MSMES (1984–2002)

4.1 Policy Context

The balance of payment crisis of 1991 and the connected structural reforms initiated by the government brought in a paradigm shift in the existing fiscal scenario of the country. Industrial licensing and import restrictions were eased by incorporating the recommendations of the tax reforms committee of 1991. Reduction of income tax rate, rationalisation of excise duty and implementation of a Value Added Tax system were the key outcomes of the committee recommendations. (Panagariya, 2008).

4.2 Benefits for MSMEs

Reduction of the income tax rates reduced the fiscal cost of operating formally (Chelliah, 1991). The presumptive taxation scheme under section 44AD of the Income Tax Act for small enterprises calculated the taxable income as a fixed percentage of the gross receipts, which reduced the cost of maintaining detailed accounts (Government of India, 2000). This scheme made formal tax compliance viable for proprietorships and small partnerships. The extension in the MODVAT system, in terms of including capital goods and other inputs, benefited the SSIs. So, firms maintaining proper accounts and tax documents are able to claim input tax credit. This incentivised the firms to operate formally at least in the manufacturing sector. (Purohit, 2006).

4.3 Burdens and Transition Challenges

On the other hand, the opening of the economy removed the advantages of SSIs enjoyed under the reservation policy and exposed them to international competition. The import of products under the reservation category from countries like China makes the existence of the SSIs more unpredictable, and the nominal tax concessions and exemptions are not enough to enable the firms to compete with international players (Mohan, 2002).

The introduction of MODVAT reduced the cascading effect, but the magnitude of reduction was very small, and the regulations are more complex. This again nurtured the informality in the economy. The exclusion of the services from all the tax mechanisms also pushed the SSIs to concentrate more on services than production. (Rao & Singh, 2006).

4.4 Introduction of CENVAT (2004)

The introduction of CENVAT as a replacement of MODVAT in 2004 extended the input tax credit to excise duties and service tax, enabling the firms to claim input credit on advertising, consulting, and other services used in manufacturing, reducing the cascading to some extent. The complexities in the law and the resource constraints of the small firms to maintain professional accounts did not allow them to take the benefits of input tax credit (Purohit, 2006).

4.5 System Assessment

The tax reforms in the liberalisation era were somewhat positive for the MSMEs in terms of reduction of income tax rates, presumptive taxation, increased threshold and partial input tax credit through MODVAT/CENVAT. The tax reforms happened in isolation and at the state level, leaving the taxation system fragmented; the compliance burden still remained higher for the small firms. (Bagchi, 2005).

5. STATE-LEVEL VAT REFORM AND ITS IMPLICATIONS FOR MSMES: BENEFITS AND STRUCTURAL CONSTRAINTS (2003–2017)

5.1 Introduction of State VAT

An empowered committee of state finance ministers heading for the roll out of state-level Value Added Tax (VAT) across the Indian states from a time period between 2003 and 2008. The VAT system was implemented to replace the existing sales tax regimes in the states and to reduce the cascading effect, at least inside the state boundaries, to ensure a better environment for businesses to flourish. VAT was planned to be levied at each stage of production, and the manufacturers can enjoy the benefit of input tax credit at every stage of production while transferring the goods to the adjacent stage (Rao & Singh, 2006). Haryana implemented VAT for the first time, followed by other states.

5.2 Benefits for MSMEs under State VAT

The major benefit for the MSMEs is the fixation of a fixed threshold statewide for the manufacturing firms, typically a turnover ranging from 5 lakh to 20 lakh, which allowed the micro firms to stay out of the tax network, and their compliance burden became zero (Bird & Gendron, 2007). There is also a composition scheme which allows the firms above threshold and below a specified ceiling to pay a flat percentage turnover as tax, and they are not liable to comply with complex input-output accounting and record keeping. The ceiling for the composition scheme varied by state, typically between 40 and 75 lakhs. (Empowered Committee, 2005). This eliminated the cascading of taxes to a large extent within the states and benefited the MSMEs procuring their inputs from the domicile state itself. These reduced the cost of products by these MSMEs and improved the price competitiveness (Purohit, 2006).

5.3 Burdens and Limitations

Along with the benefits, the state-level VAT regime had some critical problems that were not easy to solve. The composition scheme had a major drawback: the firms registered under the composition scheme were not entitled to issue invoices to customers, and that made them unfavourable to the large and normally registered dealers, since they could not claim input tax credit without proper invoices. So, it penalised small manufacturers in their business-to-business transactions (Bird & Gendron, 2007).

The existence of the Central Sales Tax of two per cent on interstate sales, with the state Value Added Tax, was not eligible for input tax credit. The cross-border buyers from different states were not able to take the input tax credit, and the cascading still existed in the interstate trade. For MSMEs selling and purchasing beyond the state border, the cascading remained a significant burden. (Rao & Singh, 2006).

The difference in the tax rate across states for the same products was another limitation of VAT. Even though there are certain agreements between the states regarding the rate harmonisation, the numerous state-level exemptions and state-level legislation in VAT increased the complexity in the VAT structure. This led to severe tax rate differences for the same products even in

neighbouring states and indirectly promoted the informal economy. (Bagchi, 2005). The coexistence of service tax governed by the central government also intensified the complexities for MSMEs collectively dealing with goods and services (Ministry of Finance, 2009).

5.4 System Assessment

Value Added Tax implementation brought in lots of improvement and simplification in the indirect taxation scenario of the country, and this lowered the burden of MSMEs. But the change did not fully address the problems of tax multiplicity, cascading and complexity. Since the reforms happened at the state-level, the existence of centrally governed taxes like central excise duty, central sales tax and services tax highlights the lack of integrity in indirect taxation. VAT solved the issues of MSMEs transacting inside the state border to a large extent, but MSMEs engaged in interstate trade have to face a higher compliance burden and complexity (Keen & Lockwood, 2010).

6. THE GOODS AND SERVICES TAX: DESIGN, MSME PROVISIONS, AND IMPLEMENTATION EXPERIENCE (2017–PRESENT)

6.1 Constitutional and Legislative Framework

The 101st constitutional amendment of 2016 enabled the implementation of GST by inserting Article 246A, which granted the power to both the Union and the state to make concurrent laws on Goods and Services Tax. The Central Goods and Services Tax (CGST) Act 2017, Integrated Goods and Services Tax (IGST) Act 2017 and respective State Goods and Services Tax (SGST) Act 2017 collectively constitute the legislative framework of GST. The GST council, incorporated under Article 279A, was the supreme body taking decisions on the functioning of GST, chaired by the Union Finance Minister and state finance ministers as members (Ministry of Finance, 2017).

The Goods and Services Tax subsumed and replaced the bulk of indirect taxes, such as central excise duty, service tax, VAT, central sales tax, entry tax, octroi, and a dozen other central and state levies with a single, destination-based, multi-stage tax with full input credit across the goods-services boundary (Ministry of Finance, 2017).

6.2 Benefits for MSMEs under GST

The GST composition scheme for dealers with 1.5 crore turnover in manufacturing and 50 lakhs in the service sector ensures a fixed per cent payment of tax on turnover, similar to the composition scheme in the VAT period and the turnover threshold was increased in GST, enabling many of the MSMEs to enjoy the benefits of the composition scheme. This will reduce the compliance burden of the firms to a large extent, only by submitting a single quarterly return and a summary of outward supplies (Ministry of Finance, 2019). This scheme substantially simplifies compliance for the smallest MSMEs.

Increased and uniform exemption threshold for registration, 40 lakhs for manufacturing and 20 lakhs for services, relieving the micro sector firms from compliance entirely (GST Council, 2019). This is considerably higher than the VAT-era thresholds in many states.

The subsuming of Central Sales Tax to GST enabled the cross-border input tax credit on inter-state transactions. For example, a manufacturer in Gujarat selling to a buyer in Maharashtra pays IGST, which the buyer claims as credit against his SGST or CGST liability, a seamless credit mechanism that the pre-GST system entirely lacked (Keen & Lockwood, 2010). And for the first time, input tax credit was made available for the services also. The services embedded in manufacturing, like legal, advertising and transporting services, are now eligible for input tax credit, and this removed a significant cascading element for MSMEs that relied heavily on outsourced services (Agarwal & Chakraborty, 2019).

6.3 Burdens and Transition Difficulties

The digital architecture of GST was the first of its kind in the Indian indirect tax mechanism. Monthly digital return filing, invoice matching and electronic refund processing imposed a heavy compliance burden on the MSME firms with limited infrastructural and technological capabilities. The filing of GSTR-1, GSTR-2 and GSTR-3 monthly and one annual return a total of thirty-seven returns in a year, was much higher than the pre-GST period and far exceeding the compliance burden too (Agarwal & Chakraborty, 2019).

Delayed input tax credit refunds for exporting MSMEs created working capital crunches. Studies found that refund delays of 4 to 6 months were common in the first year, resulting in significant interest costs for small producers operating on thin margins (Rao, 2019). The exclusion of composition dealers from issuing standard GST invoices persisted during the GST period, reducing their attractiveness in B2B transactions. This pushed the small firms below the threshold to normal registration and increased the tax compliance burden (GST Council, 2019).

The inverted duty structure in sectors with high MSME concentration, such as textiles, food processing, and construction materials, and the anti-profiteering provisions to ensure transparent transfer of price reductions to consumers, created uncertainty for small enterprises about their pricing decisions. (Ministry of Finance, 2017).

6.4 System Assessment

Goods and Services Tax represented the most-awaited rationalisation in the indirect tax system of India. For MSMEs, GST offers a large number of benefits through the elimination of CST, integration of goods and services together, expansion of input tax credit for interstate transactions, a composition scheme for smaller firms and an increased threshold of registration. But the implementation of a taxation mechanism that needs a robust technological foundation imposed a regressive burden on the small and resource-constrained MSMEs. The introduction of the QRMP (Quarterly Return Monthly Payment) scheme for small taxpayers, threshold revisions and rate rationalisation reflected a learning process that the preceding systems rarely exhibited (Rao, 2019).

7. Comparative Analysis: State-Level VAT versus GST for MSMEs

The following table consists of a systematic comparison of the state-level VAT regime with the Goods and Services Tax regime, with various dimensions that are more relevant to the MSME sector enterprises.

Table 1: Comparative Analysis of State-Level VAT and GST for the MSME/SSI Sector

Dimension	State-Level VAT (2003–2017)	GST (2017–Present)
Coverage	Only for goods, Services are taxed through Service Tax	Goods and services unified
Cascading	Intra-state cascading reduced to a large extend.	Input Tax Credit across state borders eliminates cascading to a large extend
Exemption Threshold	Varies across states (Rs 5–20 lakh)	Uniform threshold across the country; Rs 40 lakh (goods) and Rs 20 lakh (services)
Composition Scheme	Composition scheme was available but the ceiling varies across states	Uniform ceiling of 1.5 crore with quarterly return filing option.
Input Credit	Only for intra-state transactions of goods, services are ineligible.	For all transactions for both goods and services.
Rate Structure	Varies across states	5%, 18%, and 40% common national schedule
Compliance Burden	Paper based state-level filing of returns. Limited digital requirements.	Fully digital compliance. Dedicated GST portal for compliance.
Inter-State Trade	Possible with 2% Central Sales Tax without ITC	No specific tax for interstate trade. Full ITC available.
Composition Dealer B2B	Unable to issue tax invoices.	Same limitation; QRMP scheme reduces the return filing frequency
Number of Returns	Monthly/Quarterly returns relatively simple process	Normally 37returns per year reduced to ~5 if QRMP scheme opted
Refund Mechanism	Under state control.	Centralised GST network, initial issues are getting addressed.
Benefit to MSMEs	Exemption threshold and composition	Higher and uniform threshold, broader ITC framework and seamless cross border trade.
Key Drawback for MSMEs	Inter-state cascading, multiple rates in different states, exclusion of services	Digital compliance and higher compliance burden. Limitations of composition scheme

From the comparison table, it was clear that GST was superior to the pre-existing VAT regime. Integration of services, easy cross-border trade and better ITC mechanisms are the major benefits. At the same time, digital filing requirements and an increased number of returns enlarged the need for better infrastructure and professional expertise for tax compliance. This made the tax compliance burdensome for the small, resource-constrained MSMEs. Compared to the predecessors, the addressing of implementation weaknesses and revisions is improved in the GST regime. Introduction of the QRMP scheme, removal of reverse charge mechanism, revision of thresholds and rate rationalisation are some of the examples of the institutional learning (Rao, 2019).

The unresolved issue in GST, which existed in the VAT regime, is the composition B2B gap. Composition dealers are not entitled to issue the tax invoice, which enables the buyers to claim ITC. In the VAT period, the gap was only at the state level since there was no inter-state tax credit. But now in the GST regime, the gap widens because the scope of ITC has broadened to the national level. Introduction of a reverse charge (with the tax borne and remitted by the buyer under a reverse charge mechanism), like a mechanism for composition dealers, might address this issue without imposing the full compliance burden on small firms. (Bird & Gendron, 2007).

8. STRUCTURAL CONTINUITIES IN MSME TAXATION: POLICY IMPLICATIONS

8.1 The Informality Trap

The existence of huge informality in the economy was also a result of the tax mechanism prevailing in the country. In developing economies, there was a significant portion of informal enterprises with less productivity, paying lower taxes, limited access to the formal credit market, and continually remaining small (La Porta and Shleifer, 2014). In India, the exemptions, reservations and composition schemes incentivised the small firms to remain small and resulted in a low-productive informal manufacturing sector.

8.2 The Missing Middle

The problem of the missing middle arose due to the paucity of medium-scale enterprises with huge potential to become large-scale manufacturers. Indian firms clustered artificially below the registration thresholds to enjoy the exemption benefits by suppressing their productivity (Hsieh and Olken, 2014). The introduction of the composition scheme in GST motivates the firms to move forward, but it does not fully address the issue of below-threshold clustering.

8.3 Compliance as a Regressive Tax

Djankov et al. (2010) analysed that the compliance burden of taxes is regressive on the firms based on their size since small firms and large firms have to follow similar compliance procedures. Indian taxation systems imposed a higher compliance burden on small firms in terms of complex

compliance procedures, multiple taxes and formal record-keeping. GST's digital compliance mechanism enables simplification, but the initial transition cost increased the compliance burden of MSME firms (Agarwal & Chakraborty, 2019).

9. CONCLUSION

The indirect tax mechanism of India in the post-independence period, particularly on the MSMEs and small-scale industries, can be broadly analysed through four phases. The initial excise framework has lots of exemptions and generous incentives. Secondly, the License Raj era of cascading and high-income tax. Followed by the liberalisation era of MODVAT/CENVAT and the state-level Value Added Tax, with the currently existing nation-wide uniform taxation system of Goods and Services Tax. Each regime had its own benefits and burdens on the small-scale industries as well as the economy as a whole.

The state-level VAT system was a tremendous improvement from its distorted predecessors. Introduction of inter-state input tax credit, composition scheme and a broad agreement on the thresholds and rates among the states have made the VAT regime comparatively better than the previous regimes. But the fragmented tax system with central excise duty, Central Sales Tax, and Services Tax still kept complexities in the tax compliance. With the introduction of GST, these issues were addressed by and large through enabling inter-state input tax credit and subsumption of fragmented taxes. Digital compliance, increased compliance burden, limitation of composition schemes, and delay in tax refunds are still posing challenges in proper tax compliance, but the timely intervention of the GST council was addressing these issues and making GST a better taxation mechanism for MSMEs compared to pre-GST tax regimes.

In India, the role of small enterprises in the country was crucial, and their survival was essential to address the problems of unemployment and equitable development. The tax policies of the country are always considered the MSMEs with priority in every aspect of taxation, and the GST also retained the protective measures through exemption thresholds and the composition scheme. If GST succeeds in its objective, it will ensure a formal MSME ecosystem with better digital, financial and managerial capabilities with huge potential for growth to medium and large enterprises.

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