

Impact of Direct Tax Policies on the Growth and Tax Compliance of MSMEs in India

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ABSTRACT

Micro, Medium Enterprises are very important for the Indian economy. They help a lot of people get jobs and they also make things that we use. The Government of India wants to help these Micro, Small and Medium Enterprises grow so they made some tax rules. These rules are supposed to help Micro, Medium Enterprises and also make sure they pay their taxes. This paper looks at these tax rules that apply to Micro, Medium Enterprises, in India. It also tries to understand how these rules affect the growth of Micro, Medium Enterprises and if they follow the rules or not. Micro, Medium Enterprises are a big part of the Indian economy so it is good to know how these tax rules work for them. The study looks at information that was already collected from government books, policy papers, school journals and official websites. It checks things, like income tax rates, special tax plans, things you can deduct things you do not have to pay tax on and special help for companies to understand how they affect how much money companies make, how much they can put back into their business how they build up their capital and how well they follow tax rules on their own. What the study found out is that making tax rules simpler and giving companies tax rates has helped small and medium sized businesses, which are also called MSME to grow and follow tax rules better. MSME growth and compliance levels are doing well because of these tax regimes and special tax rates. The thing is, things like not knowing about rules and having to follow a lot of procedures are still problems. These problems are especially bad for small businesses. The study says that we need to make tax laws simpler, have rules that do not change all the time and tell people more about what they need to do. This is necessary to make direct tax policies work better for Micro Small and Medium Enterprises in India. We need to do these things to help Micro Small and Medium Enterprises in India.

Keywords: MSMEs, Direct Tax Policies, Tax Compliance, Presumptive Taxation, MSME Growth, Income Tax, Digital Tax Administration, India

INTRODUCTION

The Micro, Small & Medium Sized Enterprises (MSMEs) sector is regarded as one of the most important sectors in India's economy with respect to Gross Domestic Product (GDP), Employment Generation, Exports and Regional Development. MSMEs provide a foundation for entrepreneurship, innovation and Inclusive Economic Growth. The importance of MSMEs to the economy has been recognised by successive governments through policy intervention, with taxation policy - specifically Direct Taxation -

being one of the key areas of focus for policy intervention. Impact of Direct Tax Policy on MSMEs The Direct Tax Policy in India has a direct impact on MSMEs in terms of Income Tax, Corporate Tax Rate, Tax Exemptions, Tax Deductions, Presumptive Taxation, and Compliance Mechanism, all of which affect how MSMEs will respond to these taxes and how they will perform financially. An efficient Direct Tax Policy could foster Business Expansion, Capital Formation and Formalisation whereas an inefficient or complex Direct Tax Policy could increase Compliance Costs, reduce Voluntary Compliance and restrict Growth. Because many MSMEs in India operate informally, it is vital that the Direct Tax Policy be effective and efficiently structured in the implementation process. India has undergone significant reforms in its Direct Tax structure in the last few years as part of its efforts to simplify processes, improve Tax Transparency and increase Tax Compliance. The introduction of methods to streamline the operations of MSMEs by offering reduced corporate tax rates, presumptive taxation as provided by the Income Tax Act, improving digital filing options and implementing faceless assessment systems is an example of how the Government has tried to alleviate these MSMEs' administrative burden with the intention of making it easier to operate a business. However, even with these measures in place, MSMEs still face significant challenges due to tax complexity, a lack of knowledge, rigid procedures, and the expense involved with compliance; all of these factors can significantly impair an MSMEs potential for growth and compliance behaviour. It is therefore necessary to critically assess the impact of direct taxation policies on MSMEs. The aim of this research is to examine the interplay between direct taxes and the growth process and compliance behaviour of MSMEs in India. Furthermore it aims to determine whether or not the current legislation regarding tax has effectively balanced between the requirements of revenue generation and the need to further develop MSMEs. By reviewing the policy outcomes, identifying the structural challenges, the research will also contribute to the growing discussion regarding the effectiveness of tax policy in promoting sustainable MSME growth in India.

REVIEW OF LITERATURE

Direct tax measures play a significant role in shaping the development of Micro, Small and Medium Enterprises (MSMEs). Literature shows a broad consensus that favourable tax structures — such as lower tax rates, simplified regimes, and targeted incentives — promote MSME growth and formalization, whereas high tax rates and complex procedures discourage expansion. Bhalla et al. (2022) argue that simplified tax systems and technological improvements in tax administration enhance business performance and reduce compliance burden. Similarly, OECD (2019) highlights that well-structured tax regimes improve ease of doing business for small firms. Policy reforms such as the reduction of corporate tax rates for new manufacturing firms have been intended to increase reinvestment capacity and global competitiveness of Indian enterprises. Empirical studies indicate that such tax incentives encourage small firms to formalize operations and gain better access to finance and government schemes (Bhalla et al., 2023). However, Gupta (2024) warns that high marginal tax rates and frequent regulatory changes can negatively affect microenterprises by reducing profitability and restricting business expansion. Tax compliance requirements are also found to influence the formalization decisions of MSMEs. Several studies note that many small firms remain informal to avoid the cost and complexity of tax procedures (Sury, 2022; Jowardar, 2025). Compliance costs are often described as regressive, disproportionately affecting microenterprises due to limited administrative capacity (Shroff et al., 2022; Novikasari et al., 2021).. Research shows that extensive documentation requirements and professional fees reduce resources available for productive investment. This creates an incentive for very small firms to stay outside the

formal system. Evidence further shows that formal registration levels among MSMEs remain low, indicating the deterrent effect of regulatory and tax-related procedures. Scholars therefore emphasize that reducing compliance burden and improving awareness are critical for enhancing voluntary compliance among MSMEs. Overall, the literature suggests that while supportive direct tax policies can stimulate MSME growth and compliance, excessive complexity and high compliance costs continue to limit the full realization of these benefits.

RESEARCH METHODOLOGY

In this study, a descriptive and analytical design has been utilized to understand the impact of direct tax legislation on the growth and tax compliance of Micro, Small, and Medium Enterprises (MSME) in India. The descriptive sections of this research will analyse the design and development of the direct tax legal framework which affects MSMEs while the analytical components will evaluate the effect of the direct tax framework on MSME growth, the ability to reinvest into their businesses, formalisation of their businesses, and compliance behaviour. Because there will be no manipulation of variables within this study, a critical examination of the policy provisions and their outcomes will allow for a broader economic understanding of the role of taxation on the development of MSMEs in India.

The research presented herein is based solely on secondary sources therefore there are no primary data respondents. Secondary source data for this case study includes data pertaining to taxation for MSMEs, Indian Government policy documents pertaining to MSMEs, Institutional records pertaining to MSMEs, and published research studies concerning MSMEs to form the population of this research. Following the compilation of reliable data from the Ministry of MSME, Central Board of Direct Taxes, Ministry of Finance, Reserve Bank of India, throughout the data will be drawn from OECD publications as well as published outputs from MSME industry associations such as FICCI and CII. In addition, there will not be a sample size calculation due to the absence of a survey or questionnaire but instead rely on selecting relevant and credible published documents to provide data for analysis purposes.

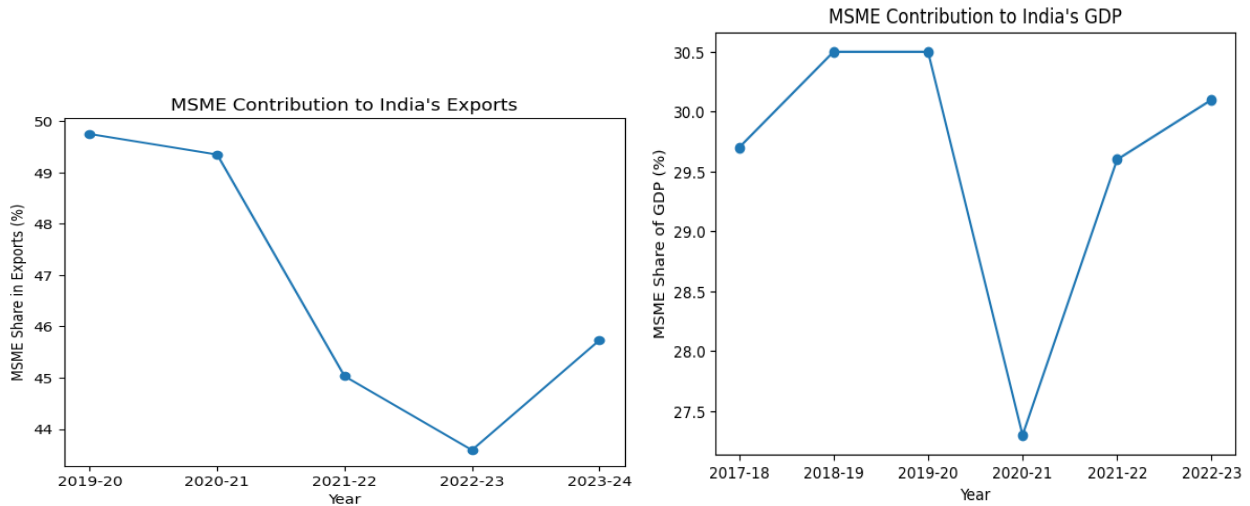
Since the study is based on secondary data, a pilot study didn't take place. The research is also guided by the conceptual analytical framework, where variables include independent variables of tax rates, presumptive taxation systems, deductions/exemptions, digital tax administration, and MSME-related growth indicators, tax compliance behavior(s) will serve as dependent variables. The study period will be over approximately the last 10-15 years, with an emphasis on the reforms that were instituted after 2016 (i.e., corporate tax rate reduction, expansion of presumptive taxation provisions, digital tax administration systems).

Cronbach's Alpha would not apply due to there being no primary survey instrument developed. For data analysis, qualitative and comparative analytical methods will be used to interpret tax policy trends and reform outcomes, to assess the impact of tax policy on MSME profitability, formalisation, and ease of compliance. Comparing pre-reform and post-reform scenarios will also assist with identifying policy improvement(s) and continuing challenges such as: compliance costs; cash flow constraints; complexity of policy; and lack of awareness. The study is limited due to the reliance on secondary data and the fact that firm-level measures of behavior do not exist; however, it does provide insight into the relationship between direct tax policies and MSME growth and compliance in India.

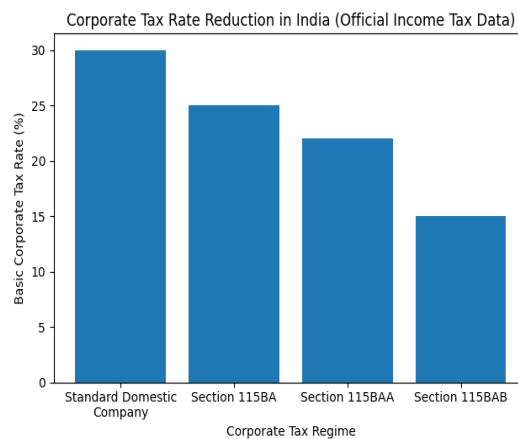
DATA ANALYSIS:

India's Micro, Small and Medium Enterprises (MSME) sector is one of the most crucial drivers of econ-

omic growth for the nation in terms of job creation, industrial production, export revenues and contributions towards GDP growth rates. The impact of direct tax laws such as those for income tax, corporate tax, presumptive taxation and digital tax administration on the MSME's growth performance and tax compliance behaviour cannot be overstated. This study analyses the data to assess how specific direct tax reform initiatives have impacted the growth and compliance level of MSMEs and the major challenges facing the MSME sector.



Direct tax law reforms undertaken by the Government of India have mainly focused on simplifying tax structures and lessening the tax burden placed on smaller enterprise taxpayers. Of these direct tax reform initiatives, one of the key initiatives that has contributed to enhancing MSME growth has been the reduction of the corporate tax rates on corporations with lower turnover amounts. As such, this reduction in corporate tax rates has allowed for greater post-tax profits (retained earnings) by MSMEs that can then be reinvested back into business development, technological advances, workforce training and job creation. The financial position of MSMEs should improve due to greater cash flow resulting from the reduction in corporate tax rates enabling them to become more competitive participating in both domestic and international markets.



There has been significant support for the growth of micro-small-medium enterprises (MSMEs) through the use of presumptive taxation provisions (the alternatives available against the sections to detect income) in Sections 44AD, 44ADA, and 44AE, which have effectively reduced compliance burdens. Under these provisions, qualifying businesses may report their income as a fixed percent of their gross turnover,

therefore eliminating the need for detailed bookkeeping and tax audits, reducing compliance costs substantially (especially with regards to micro and small-sized enterprises who have limited administrative capabilities). The simpler way to calculate taxable income using the presumptive tax method has assisted many informal enterprises in formalizing their business, which has led to greater access to institutional financing, government schemes, and market opportunities, which has helped to create sustainable long-term businesses.

In addition to supporting the growth of MSMEs, the digitalization of taxation administration has also been instrumental in improving the outcome of taxpayer compliance in MSMEs. The digitalization of the income tax administration has made it easier for taxpayers to file income tax returns through online filing and create a more efficient process for assessing taxpayer returns and addressing grievances (faceless and call centres). Being able to reduce the extent of discretionary powers, fewer opportunities to harass, and increase transparency in taxpayer compliance (thus significantly reduce compliance stress for MSMEs) has been made possible through minimising the need for direct interaction with tax administrations through the use of digital platforms (this has removed compliance anxiety and minimised delays in the administrative process). Ultimately, this reduction in compliance issues has allowed the MSME to focus on producing and growing the company rather than on completing procedural requirements, thereby resulting in favourable impacts on operational efficiency and growth potential of MSMEs.

Tax compliance for MSME's will improve because of the direct tax reform. The introduction of simpler filing processes; lower direct tax rates; and the introduction of presumptive taxation will lead to a higher degree of voluntary compliance as many MSME's will find it easier to accurately declare income when the tax rate is reasonable and the filing process is simple. By eliminating the audit requirements that eligible MSME's are required to comply with, there is an increase in the level of confidence that MSME's have in the tax system and a reduction in their fear of being scrutinized by the tax authority. Consequently, the number of registered MSME tax payers is increasing which is benefiting the MSME's by strengthening the tax base and enhancing transparency and accountability within the tax system.

In spite of these positive advances, the data analysis shows that there are still a number of ongoing challenges that hinder the growth and compliance of MSME's. The most pervasive challenge that is affecting the compliance level of MSME's is the complexity of tax laws and the frequent changes to tax policy. The continuous changes to the tax laws create a level of uncertainty that makes it difficult for MSME's to plan for and invest in the long-term as well as develop a long-term financial strategy. Due to the fact that micro and small enterprises do not have the required level of technical expertise to keep up with the constantly changing regulations, they are more likely to be unintentionally in non-compliance.

Another issue is compliance costs. While digital systems have simplified some parts of the process, MSMEs continue to hire chartered accountants and tax consultants to file returns, conduct audits and respond to notices, resulting in significant compliance costs for them. For micro enterprises with little profit margin these compliance costs can create a major financial burden. In addition to compliance costs, MSMEs are adversely impacted by cash flow constraints caused by advance tax payments and TDS. Advance payments of tax decrease the working capital of MSMEs, while delayed refunds from TDS increase pressure on liquidity. Limited working capital limits the operational capabilities of MSMEs, as they will be unable to invest in technologies or expand their production capacity, thereby stunting their growth.

A lack of awareness regarding available tax benefits and incentives represents yet another challenge for MSMEs according to the analysis. Many MSMEs do not know about available deductions, exemptions,

and presumptive schemes that could significantly decrease their overall tax liability. Limited financial literacy among MSMEs coupled with the insufficient dissemination of information prevents them from taking advantage of supportive tax measures, contributing to a lower perception of fairness in the tax system and consequently reduced motivation to comply.

Another complicating factor to tax compliance amongst MSMEs is their weak accounting and recordkeeping practices. Most MSMEs rely on manual or informal recordkeeping techniques and do not employ trained accountants; therefore, there is a much higher dependency on external professionals and greater potential for error in preparing taxes, penalties, and disputes. The costs associated with these issues vary by type of MSME; micro enterprises are under far greater compliance pressure than medium-size companies that have greater access to financial and administrative resources.

Overall, the finding suggests that the direct taxes of India contribute to the growth of MSME's and their compliance with tax regulations through mechanisms to lower tax rates, provide presumptive taxation clarity and major IT improvements. The efforts have improved higher profitability and greater formalisation, increased voluntary compliance. However, some of the existing challenges (in the areas of complexity of rules and regulations, compliance costs/ and cash flow challenges for business, and lack of knowledge/understanding) all serve to limit capacity of MSME's to their fullest potential. The solutions required to address these challenges include: policy consistency; programs for targeted awareness within MSME businesses; improved process simplification; and improved support mechanisms.

DISCUSSION

The study looks at how direct tax policies affect the growth and development of Micro, Medium Enterprises in India. What the study found out is that taxes are not a way for the government to get money but they also play a big role in shaping the economy and the financial health of Micro, Small and Medium Enterprises (Sawhney, 2018; Pandey, 2025). The way taxes are structured, like income tax rates and corporate tax concessions, has an impact on how much money Micro, Small and Medium Enterprises have left after they pay their taxes. When a company has money left over it has more cash to use. This means it can invest in technology, build better infrastructure and hire more people. This is really good for the company because it helps the business keep going for a time. The company can use its retained earnings to do all these things. That is why retained earnings are important for business sustainability. Retained earnings are very important for the long-term success of a company, like this. The main thing that came out of this study is that simple tax rules are really good. For example the presumptive tax schemes in the Income Tax Act like the ones in Sections 44AD 44ADA and 44AE are very helpful. These schemes make it easier for businesses to follow the rules by not making them keep a lot of records and by not making them go through audits. This makes things a lot less complicated for businesses. As a result more businesses are happy to follow the tax rules on their own. The Income Tax Act and its schemes like the ones in Sections 44AD 44ADA and 44AE have also made it easier for businesses that were not registered before to become formal businesses. The Income Tax Act and its presumptive tax schemes have really made a difference. This shows that simple rules can work better than enforcement when it comes to getting more people to pay taxes and being open about money in the MSME sector. The MSME sector is where we need to focus on making things simple so that people can easily pay their taxes and be honest about their finances. This is what will really help the MSME sector in the run. The study also shows that changing tax rules a lot can cause problems. When tax rules keep changing it is hard for people to know what to expect (OECD, 2021; Safitri, 2025). This can stop small and medium sized enterprises or MSMEs

from making long term plans and investments. MSMEs need to know what the tax rules are going to be so they can plan for the future. If tax laws are simple and do not change a lot it helps MSMEs feel more secure. Simple tax rules and not having to do a lot of paperwork can make entrepreneurs more confident and more likely to follow the tax rules on their own. MSMEs need tax rules that do not change a lot so they can make business plans. The thing is, we really need to make people more aware of taxes and help them learn more about it. A lot of businesses, especially the really small ones in towns and villages do not know much about the tax benefits they can get and how to use digital systems to pay taxes. We should have programs that teach people about taxes, have workshops and use the internet to reach people in different languages. This will help people understand taxes better and be able to take part in the economy in a way. If people know more about taxes they will be less likely to break the rules by mistake because they do not know any better. Tax awareness is important for businesses, like MSMEs and we should focus on this. MSMEs need to know about tax benefits and how to use compliance systems. Reducing the compliance burden for enterprises is really important. We need to make it easy for them to file their returns and get help from professionals without spending much money. Micro enterprises should be able to get advice when they need it. This way micro enterprises can focus on doing their work instead of dealing with a lot of paperwork. If we make our digital infrastructure better like the helpdesks and facilitation centres, micro enterprises will have a time using online tax platforms and e-governance systems that are always changing. The study also points out that it is really important to make advanced tax mechanisms more sensible and to make sure that Tax Deducted at Source (TDS) refunds are processed on time. MSMEs usually do not have a lot of working capital to play with. When refunds are delayed or tax payments have to be made at fixed times it can cause problems with how they operate. Having payment structures that're more flexible and getting refunds out faster would really help MSMEs keep money coming in and reduce the financial pressure on small businesses, like MSMEs. Finally, improved coordination between MSME development institutions and tax authorities can ensure that tax policies remain aligned with sector-specific needs. A balanced approach that combines simplified compliance, policy stability, awareness initiatives, and administrative support is essential for strengthening direct tax compliance while fostering sustainable growth of MSMEs in India.

CONCLUSION

This study looked at how direct tax policies affect the growth and tax compliance of Micro, Medium Enterprises in India. The results show that direct taxes do two things. They help the government get money. They help businesses do better. Things like tax rates, simpler tax schemes and online tax systems have helped Micro, Small and Medium Enterprises pay their taxes on time and become more formal businesses. Micro, Medium Enterprises have seen a lot of benefits from these changes. Things are easier for businesses now because they do not have to follow as many rules. This means they get to keep more of the money they make. Small businesses can use this money to make their company bigger, hire people and get new technology. Small businesses can really. Do more things when they have more money to use for business expansion, employment generation and technological adoption.

The study also finds some problems that still exist. For example, many people do not know about the tax rules and small businesses have to spend a lot of money to follow these rules. The government keeps changing its policies, which's also a problem. Additionally small businesses have trouble with cash flow because they have to pay taxes in advance and deal with Tax Deducted at Source mechanisms. All these

issues mean that even though some changes have helped the government needs to make changes and give more help to small and medium sized businesses so that they can all grow and do well.

The future of research is about doing studies on the ground to see what Micro, Small and Medium Enterprises think about tax policies and how they really comply with them. We should do studies that compare areas and sizes of Micro, Small and Medium Enterprises. We should also look at numbers to see how changes in tax policies affect how well Micro, Small and Medium Enterprises do. This will give us an understanding of whether direct tax policies really work for Micro, Small and Medium Enterprises, in India in the long run. Micro, Medium Enterprises will benefit from this kind of research.

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