CATALYST
Inclusive Cashless Payment Partnership

# LEVERAGING **GST** FOR DIGITAL PAYMENTS

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# 1

# Introduction

## A. The MSME Landscape

India's micro, small and medium enterprise sector is a key engine of growth for the economy, with its 45% contribution to industrial output, over 40% share in exports, and employs more than 100 million people – next only to agriculture.[1] In spite of these impressive numbers, the overall contribution of the sector to national Gross Domestic Product is not on par with other middle and high-income economies where MSME contribution lies in the 40-80 percent range.[2]

Lack of access to affordable, institutional finance remains one of the biggest hindrances to MSME growth in India – merely 5% of small businesses have access to finance from the banking sector. Informal firms account for nearly 77% of all MSMEs in developing countries, and the credit gaps faced by them are often more pronounced as compared to their formal counterparts.[3] An important characteristic of the MSME segment in India is that enterprises operate in a largely cash-based economy and integration of Information and Communications Technology (ICT) into operations and workflows is limited.[4]

## B. The GST regime and its Implications for MSMEs

In July 2017, the Government of India introduced a new indirect tax regime of the Goods and Services Tax that replaced the erstwhile regime of multiple, cascading indirect taxes which included central excise duty, service tax, additional customs duty, surcharges, state level VAT and Octroi. The introduction of GST was envisaged to create a unified national market, to bring in greater transparency in tax levels and to improve tax compliance at reduced cost for taxpayers.

Implementation of GST has cast a wider tax net than the previous indirect taxation regimes by including more MSMEs in its ambit. The new tax regime, and its pursuant liability thresholds, have significant ramifications for MSMEs. Under the previous tax regime, an enterprise with a turnover of INR 15 million or less was not required to comply with the provisions of the Excise Law. The current tax regime lowers this threshold to INR 2 million. Consequentially, more merchants have been included in the tax net and an increasingly higher number among them are liable to pay the tax, and consequently bear the compliance costs.

While the intent of the indirect tax reform has been lauded by industry, concerns have also been raised regarding its disruptive impact on the MSME segment, coming at the heels of demonetisation in 2016.[5] After a year of GST implementation, small enterprises are still grappling with issues related to the input tax credit system, frequent change in rules and the steep penalty for late filing. For the purposes of this paper, we limit ourselves to the implications of GST on ease of doing business and tax compliance and related aspects for small businesses.

[1] *Annual Report, 2017-18, Ministry of MSME, https://msme.gov.in/sites/default/files/MSME-AR-2017-18-Eng.pdf*

[2] *The new wave Indian MSME: An action agenda for growth, KPMG and Confederation of Indian Industry, March 2016. Available at: https://assets.kpmg.com/content/dam/kpmg/pdf/2016/03/The-new-wave-Indian-MSME.pdf*

[3] *Micro, Small and Medium Enterprises in India: A research study on needs, gaps and way forward, International Finance Corporation (World Bank Group) and Government of Japan, November 2012. Available at: https://www.ifc.org/wps/wcm/connect/4760ee004ec65f44a165bd45b400a808/MSME+Report-03-01-2013.pdf?MOD=AJPERES*

[4] *Overall, only 8% of total personal consumption expenditures and 26% of Micro Small and Medium Enterprises (MSMEs) to supplier payments are estimated as non-cash. Source: India's Digital Future, Morgan Stanley Research, Oct 2017.*

[5] *https://www.business-standard.com/article/economy-policy/one-year-of-gst-compliance-still-a-challenge-for-small-business-owners-118070100625_1.html*

# 2

# Catalyst wholesaler survey on GST

Catalyst conducted a qualitative study[6] to understand pain points around GST compliance for large wholesalers. Additionally, the survey tested the hypothesis whether digital payments can be used to create digital records which eases the compliance burden for large merchants. As a part of the study, six wholesalers engaged in sectors including apparel, local brands and electronics, with annual turnovers ranging from INR 20 million to INR 180 million. It was observed that traders in the wholesale or B2B segment generally have a large number of employees and therefore handling cash and compliance is a hassle if performed manually. In addition to these costs, the current GST framework created pain points for these wholesalers in terms of increased compliance procedures, updating their existing technology and working capital crunch, among others.

The study suggested that the GST filing process can impose significant compliance costs on small businesses. The incremental costs from GST compliance can be broadly classified under the following categories:

- Cost of GST compliant systems and softwares e.g. Enterprise Resource Planning software, invoicing and billing software, accounting software, etc. – INR 10,000 p.a.
- Personnel costs associated with outsourcing of compliance mandates to accounting/tax professionals – INR 30,000 p.a.
- Training costs associated with building in-house capacity to adhere to compliance norms – INR 5,000 p.a.

The associated costs, as much as INR 100,000 p.a. for some firms, pose a significant hurdle for small businesses that have come under the ambit of GST Act due to the reduced INR 2 million turnover threshold.  Given the complexity of GST filing and audit formats, tax rates and HSN code identification issues, our target group of small businesses lack the in-house capacity to execute these functions internally.

[6] *Study was conducted by GST Street*

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# Digital payment channels and ERPs

A central aim of the GST was to ensure increased tax compliance by businesses. However, after implementation, there are some key challenges that merchants face with GST filing and compliance, which keeps it far from achieving its objective. Filing returns has become more complex in the new GST regime, specifically for firms who used to file only two returns every six months but now have to file three returns every month along with an annual return.[7] The requirement to file invoice level data and invoice matching with the suppliers for input credit just adds to the complexity. Another key challenge is the multiple tax rates that are in place even under the GST framework. The rates not only vary with the type of product/service a merchant deals in, but also on the value of such product/service.[8] All these factors, including those discussed previously, taken together have led to increased compliance cost for businesses, particularly the small and micro ones.

Businesses frequently use accounting solutions and chartered accountants to execute the compliance procedure. All merchants surveyed in the Catalyst wholesaler study used an accounting software to file their tax returns. Accounting software or ERP (Enterprise Resource Planning) solutions, as they are formally known, are able to take care of the tax returns for a business. However, currently the reconciliation of the payment for a particular transaction is done manually. A digital payments solution linked to ERPs will automate this and increase ease of compliance. This could induce small and micro merchants to adopt digital payment methods organically for their business operations. In this section, we explore the features that ERPs in India currently have to offer and how an accounting solution with a payments integration may help in easing compliance requirements for small businesses, and thus act as a hook for digital payments.

As per the Catalyst survey of wholesalers, the tax compliance function is currently executed using accounting and ERP software such as Tally, Marg, Busy, Quickbooks, and others. They provide users with services such as billing & invoicing, payment & expense handling, inventory management and taxation, among others.

However, the survey was conducted among large wholesalers and smaller merchants who may be executing the compliance procedure differently. Presently, smaller enterprises may only generate paper-based invoices to record business transactions. These paper invoices are digitized by the firm's accountant who executes the subsequent compliance requirements. The cost of employing an accountant is a compliance related cost that GST liable firms are required to bear. There are vendors on the market like *SahiGST* or *Cleartax* that offer tax filing software, but with pricing ranging from INR 4,000 through INR 12,000 it is unclear if smaller businesses subject to tax will avail of them.

A better understanding of ERP solutions may shed more light on how digital payments integrated with ERPs may add value to businesses. In the process of filing GST returns, ERPs manage the whole workflow from generating the invoice for the sale, making the accounting entry for it and generating appropriate

[7] *GST Council on 21 July 2018 allowed quarterly filing of returns for firms having turnover less than INR 50 million, however firms above the threshold have to file monthly returns.*

[8] *Over 200 days of GST: The Road Ahead, PwC India. (Available at: https://www.pwc.in/assets/pdfs/publications/2018/over-200-days-of-gst-the-road-ahead.pdf)*

returns to be filed with the GSTN. However, the invoices need to be manually reconciled with their payment status. Manual reconciliation is an added friction that B2B transactions imply for merchants who usually deal with multiple businesses, both up and down the value chain. Further, business practices often involve deferred and part payments, which adds to the complexity of manual reconciliation.

The need for automatic reconciliation of invoices was expressed by merchants in a dipstick survey of nine small pharmaceutical retailers in Jaipur, conducted by Catalyst in May 2018.[9] The survey revealed that all GST compliant pharma retailers were using an accounting software and chartered accountants to file their returns. The reconciliation, however, was done manually within the ERP by the merchant. Merchants expressed interest in an ERP plus payments solution, which could enable them to pay and send payment requests through the platform itself.
Catalyst spoke to its partner PayBee, a payments collection solutions provider, to gain insights on how such a product may be designed. Illustratively, a possible workflow is detailed below:[10]

a. Merchant makes a sale, generates an invoice for the same and maps the purchaser against the invoice within the payments-enabled ERP platform.
b. Based on the payment terms & conditions, as decided mutually between merchant and purchaser, the platform automatically sends a payment request to the purchaser.[11]
c. Purchaser receives the payment request within their ERP platform and is presented with multiple digital payment options (UPI, Net Banking, Wallet).
d. The ERP records the payment status in real time and undertakes automatic reconciliation of merchant's books.

The proposed integration reduces the frictions imposed by current reconciliation procedures. Given that reconciliation is an integral part of GST compliance, such a solution shall have an order of magnitude effect on easing GST compliance for merchants; effectively exploiting digital payments' potential in easing GST compliance. Razorpay, a payments acceptance platform, has developed a product which enables merchants to generate invoices, share them with the payer and accept payments.[12] This eases reconciliation as the merchant can tally 'Account Receivables' against 'Invoices Issued'. However, the merchant shall still have to add invoice details and other transaction information on the ERP to file GST returns, creating the friction of managing multiple platforms. To the end of seamless GST compliance, an ERP + Payments offering remains the most comprehensive solution.

[9] *Questionnaire used for the survey has been included in the Annexure 1.*

[10] *Conversation with Area Sales Manager, PayBee dated 31 July 2018.*

[11] *Proposed integration is different from the invoice enabled collect request functionality included within UPI 2.0 to the extent that ERP automatically sends a pull request as per the payment conditions whereas UPI 2.0 requires merchants to manually attach invoices in collect requests.*

[12] *See: https://razorpay.com/blog/razorpay-gst-compliant-invoices/*

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# GSTN & Payments Data Bundling to Facilitate SME credit

The periodic and regular filing of tax invoices by SMEs implies a vast database of transaction records of GST compliant merchants with the GSTN (the technological backbone of the GST ecosystem). Developers and service providers, including lenders, have access to GSTN APIs through GST Suvidha Providers. A "GSP", as it is called, offers technological solutions to other stakeholders (Application Service Providers) to connect with GST systems.[13] This data, along with other data-sets, including payments data, could be leveraged by lenders to create alternative credit scores for under-banked SMEs. The invoice data will offer commercial data-points of the SME concerned and payments data can supplement with points from variables like power and utility payments, rentals and telecom bills. Presently, the existing credit infrastructure in the country does not capture credit risk as evidenced from non-financial payables such as utility, telecom and rentals.

In the light of this status quo, GST reform presents the opportunity for policymakers to push—a through concerted marketing and SME on-boarding drives—for digitization of payments in the aforementioned use-cases on the one hand and enabling credit information companies/other data utilities to capture utility payments and telecom bills data on the other. Presently, 30% of all power bills are paid digitally[14] and the data trails created therein, coupled with the GSTN database can be utilized to construct alternative credit scores for SMEs on the basis of which they can be lent to. The incentive of customized credit products can be further used to drive adoption of digital bill payments among merchants, creating a virtuous cycle of digital payments and customized credit.

It is pertinent to note here that the RBI has recently mooted a public credit registry (PCR) that may potentially augment the existing credit information infrastructure (CICs).[15] Although it is not clear what data sources will feed into the PCR, payments data regarding utilities, telecom and even rent can potentially be aggregated there and may be made available to lenders including fintech lenders via open APIs. The GSTN data coupled with this aggregated data will then provide the basis for an alternate credit score that will facilitate credit to SMEs. Finally, the Government e-Marketplace offers an important channel for offering credit to sellers based on transactions there, including Government to Merchant (G2M) payments data.[16] Like with utilities and telecom, the G2M cash-flows through the GeM can complement GSTN data to create an alternate credit score for SMEs.

To summarise, while GSTN architecture may have limited ability to act as a direct hook for digital payments, GSTN data coupled with digitized payments use-cases across power, telecom and rentals (C2M), and across GeM to the SME sellers (G2M) offers potential for creating alternate scores to facilitate credit. Thus, policymakers should package the push for digitization of payments using GSTN data as a hook.

[13] *See: https://economictimes.indiatimes.com/small-biz/startups/flipkart-wants-to-become-gst-suvidha-provider/articleshow/58782560.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst*

[14] *BCG-Google, Digital Payments 2020: The Making of a $500 Billion Ecosystem in India (July 2016). Available at: http://image-src.bcg.com/BCG_COM/BCG-Google%20Digital%20Payments%202020-July%202016_tcm21-39245.pdf*

[15] *BCG, Digital Lending: A $1 trillion opportunity over the next five years (July 2018).*

[16] *See https://gem.gov.in/*


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# Tax Incentives

Paying digitally, however, means that all transactions are recorded and liable to be taxed. In this scenario, the consumers have to bear the erstwhile undeclared tax burden; this is an added cost imposed by digital payments. Industry experts have noted that the tax savings that result from cash-based transactions drive SME unit economics. Navin Surya, Chairman of Payments Council of India, suggested that policymakers should incrementally reduce the tax incidence on every additional rupee brought into the formal economy. The tax rate should be designed such that the small businesses can make the trade-off between the cash driven tax savings with peace of mind brought with formalization.[17] Thus, there appears to be a case for providing tax based/GST based incentives for payments done digitally to promote their usage.

This note has previously noted the value of digital B2B payments in easing compliance and facilitating credit for enterprises. A tax incentive policy can further augment these levers and turn GST into a potent hook for digital payments. The incentive can be directed at a particular stage of the business value chain that has the potential of digitizing all transactions, upstream and downstream to it. There exists a need for instituting a GST/non-GST tax driven policy that rewards enterprises for digitization of all hitherto unrecorded transactions (illustratively by lowering GST/other tax rate applicable to a class of merchants' contingent on them using digital payments to pay upstream and downstream). Empirical testing will reveal the optimum "nudge" at which the benefits from digitization for the merchant will outweigh the benefits from tax arbitrage, if any. Such evidence-based policy will facilitate formalization.

Countries have also experimented on the C2B interface. Uruguay, through its 2014 financial inclusion law, introduced VAT incentives on the use of digital means to pay. Individuals were given a tax credit to the extent of 2% on the VAT rate for payments made digitally.[18] As a result of these incentives, debit cards transactions increased seven to eight times in a span of two years. The GST Council, in a similar vein, has instituted a rebate of 20% (capped at INR 100) of the total GST amount on payments made via BHIM UPI, RuPay Cards and USSD in rural and semi-urban areas.[19] It remains to be seen if the pilots yield the desired results.

[17] *Catalyst - Interview with Mr. Navin Surya, Chairman, Payments Council of India. Available at: http://cashlesscatalyst.org/interviews/interview-mr-naveen-surya-chairman-payments-council-india/*

[18] *See https://www.betterthancash.org/news/media-releases/uruguay-makes-great-strides-toward-the-universalization-of-access-to-financial-services*

[19] *See:https://www.business-standard.com/article/economy-policy/gst-council-meet-msme-in-focus-cashback-for-digitalisation-on-pilot-basis-118080400464_1.html*

# 6

# Actionables for Policymakers

Three actionable insights can be derived from our research:

1. *ERP integration with digital payments:* Policymakers may organize a hackathon to crowdsource a solution involving an ERP platform bundled with digital payments that automatically reconciles statements against their payment status. It appears from surveyed evidence that there is a felt need for such a solution.

2. *Creation of a data utility that compliments GSTN:* Policymakers may facilitate creation of a data utility that will aggregate non-financial transactions (telecom, utility bills) paid digitally. Extant invoice level data on the GSTN network can be coupled with data aggregated by the data utility to construct an alternate credit score for SMEs that can be relied upon to lend to merchants. Campaigns targeted at pushing consumers to pay their utility, telecom (and potentially rent) bills may use alternate credit scoring as a hook for digital payments. GST can thus be an indirect spur for digital payments through the creation of alternate data-sets that can complement GSTN data.

3. *Tax Incentives to drive B2B Digitization:* An incentive framework that is targeted at digitizing B2B supply chains by reducing the tax incidence on every additional rupee brought into the formal economy must be explored.

# Annexure 1

## General Background

Name of retailer:

Type of Organisation: Pharma RetailerGST Applies (Y/N):

Using digital payments for business (Y / N):

Digital Transactions as a percentage of turnover:

What is the most preferred mode of payment for you and Why? - NEFT/RTGS/IMPS/Mobile payments/Debit/ Credit cards/ Net Banking/Cheques/DD:

Mode of Invoice and Payments:

Is Credit available from suppliers and extended to customers?

## GST

GST Registration (Y / N)

Do you maintain digital record of consumer invoices? (Y / N)

Change in Business Experience post-GST:

GST Returns (Y/N):

1. Mode - Manual/Automated

2. Help required? _______________ (Digital Solutions(Y/N), If Yes :)

    - Features used (Invoicing?):
    - Level of Satisfaction:
    - Additional features suggested (ease GST, business):

3. Additional Costs (eg: CA, Software):

Critical Pain-Points in Compliance - Invoicing/Record-Keeping/Returns:

Can Digital Payment help in easing the process of GST compliance?

Reconciling current digital transactions with GST compliance procedure:

**Technical Writers:** *Mandar Kagade, Raghav Katyal, Janak Priyani, and Diksha Singh*

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H-5, Second Floor, Green Park Extension, New Delhi - 110016
011-49096529 | info@cashlesscatalyst.org | www.cashlesscatalyst.org

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