



Advent of GST: A necessity for 'Make in India'

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Foreword

The manufacturing sector in India can play a vital role in furthering the country's aspirational economic growth, developmental agenda, and the government's target to provide employment opportunities to millions of Indian youth in the coming years.

Which is why the 'Make in India' initiative launched by the Government of India in 2014 is considered as a step in the right direction, and is critical for propelling the much needed growth in the manufacturing sector, while also aiming to raise its contribution to the GDP from 15 per cent to 25 per cent by 2022. The initiative seems to be making significant progress and has attracted greater interest and investments, as was witnessed at the recent 'Make in India' week held in February 2016.

Leveraging on its indigenous strengths of democracy, demography and demand, India is a market place in itself especially due to the 'Make in India' initiative which has allied with several initiatives that aim to facilitate the ease of doing business, infrastructure development, skill development, digital penetration in India, as well as transform taxation reforms.

From these myriad initiatives, the current white paper focusses on one of the most significant taxation reforms, Goods and Services Tax (GST). It covers the need for GST, how its impact is thorough, extending beyond tax and affecting every part of the business decision, providing a specific focus on the supply chain aspects.

GST could result in an inevitable holistic business transformation, which should lead to a new target operating model for the organisations that aim to improve profitability, cash flow, sourcing, pricing, distribution foot print as well as their Enterprise Resource Planning (ERP) systems.

In order to leverage upon this opportunity, it is important that organisations understand the potential impact of GST. They need to consider redesigning operating models, systems, processes and supply chain architecture to devise an effective implementation plan and finally execute programme management on various work streams across the value chain.

From the supply chain perspective, this may lead to a disruption in the network around six key elements, viz warehouse locations, geographical coverage, manufacturing locations, product plant mapping, manufacturing architecture, and supplier network. The objective of this paper is to elaborate on the various aspects of GST and its implication on the supply chain industry with respect to these six elements.

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Ambarish Dasgupta
Partner and Head
Management Consulting
KPMG in India





Introduction

The 'Make in India' initiative, and its key enabling initiatives launched by the Government of India, aim to provide impetus to manufacturing in the country, thereby increasing the overall economic growth to make it self-reliant. The sector has seen growth at an annual average rate of 5.77 per cent between 2011 and 2015, and the 'Make in India' campaign is expected to be one of the major initiatives to target manufacturing sector growth of 12 per cent to 14 per cent in the next three to five years¹. For this growth rate to become a reality, investors in India and overseas may have to invest significantly in manufacturing.

One of the major stumbling blocks observed over the years is the lack of ease of doing business in India. Realising this, the government had proposed many initiatives towards its facilitation; one such key initiative involved simplification of the tax structure of India and the introduction of Goods and Services Tax (GST). First proposed in 2006-07, GST subsumes several of the current indirect taxes, creating a unified tax structure for the country. The proposed framework is likely to impact overall business operations, including production, business processes, business models and geographical locations, and is expected to be beneficial to the economy and the industry.

Amongst the several reform initiatives, this white paper contextualises the 'Make in India' initiative and looks at the impending GST legislation as an enabler to ease of doing business in India. It subsequently drives through the point that from the supply chain perspective, organisations and their people must take the initiative to study the impact of GST, re-orient themselves, and implement the necessary changes to become 'GST ready'.

1. Note on Make In India, CMAI, 20 January 2015,



Opportunities and challenges to Make in India

The 'Make in India' campaign was launched on 25 September 2014 by the Government of India to facilitate the higher share of manufacturing in the GDP from 15 per cent, to 25 per cent by the year 2022², through commensurate Indian and foreign investments. Other important objectives were fostering innovation, enhancing skill development, and building some of the leading manufacturing infrastructure that can help India develop into a global manufacturing hub.

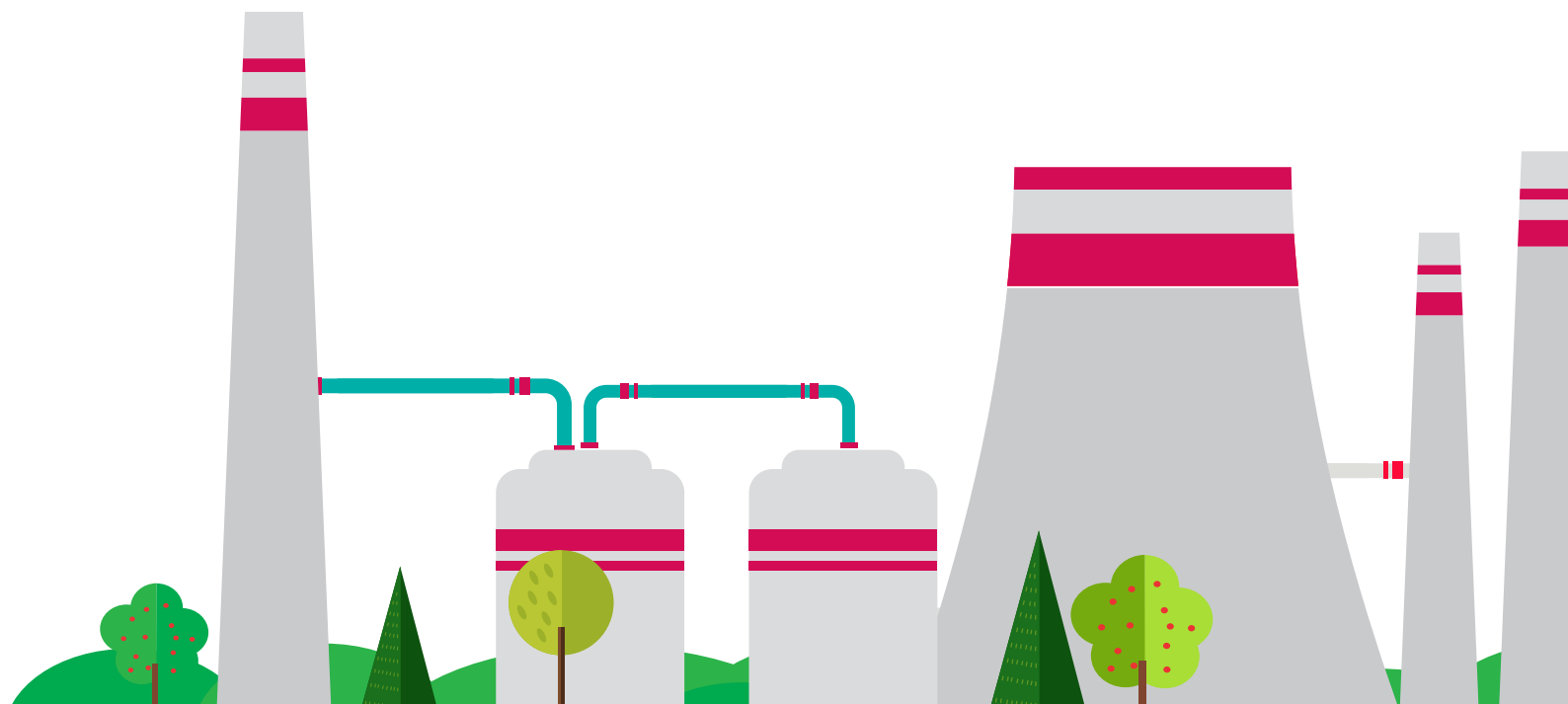
Through 'Make in India', the government is offering opportunities to businesses via the three 'D's of India — democracy, demography and demand - supported by strong indigenous strengths of a rising youth population, paired with a robust federal government structure. The demographic strength lies in the country being young, with 58 per cent of the population being below the age of 29 years³. With ageing populations rising in several developed nations, including the U.S. and Japan, this demographic potential offers India and its growing economy a sturdy advantage. The socialist and democratic setup of the country too has its edge over many of the emerging markets, with the demand being reflected by the GDP growth potential and FDI inflows.

Over the next decade (2016-25), the nominal GDP of India is expected to grow at a CAGR of 8.2 per cent. In order to contribute 25 per cent to the GDP, the manufacturing sector may need to grow at a CAGR of 11.2 per cent to reach an estimated size of INR 54 trillion.⁴

From a sectoral perspective, industrial manufacturing and automotive sectors are expected to form a significant portion of the manufacturing sector in the future, with the former expected to grow at a CAGR of 14 per cent to reach an estimated INR30 trillion by 2025, and the latter is expected to contribute to nearly INR10 trillion by the same year.

India ranked ninth in Foreign Direct Investment (FDI) procurement in 2014 worldwide, rising from rank 15 in 2013. The FDI inflows amounted to USD34 billion in 2014, which is 22 per cent higher than the previous year. This is a positive development, especially when global FDI inflows fell by 16 per cent to USD1.23 trillion⁵. Manufacturing FDI is on the rise in India, with automotive evolving as one of the most lucrative sectors. The current FDI policy is expected to further endorse India's status as a preferred destination for global investors.

2. Note on Make In India', CMAI, 20 January 2015
 3. Narendra Singh Tomar speech at G-20 Chair in Australia
 4. <http://dbie.rbi.org.in/OpenDocument/opendoc/openDocument.jsp>, KPMG in India analysis
 5. World Investment Report, 2015, UNCTAD



However, the industry, government and other stakeholders may have to significantly further their efforts in creating an enabling environment and overcome the following existing challenges:

Ease of doing business



On the 'Ease of Doing Business 2014' index, India ranks 134 out of 189 countries in terms of overall ease in tax payment⁶. The rank improved to 130 in 2015, however, it needs to be furthered to avoid firms facing delays from various compliance angles, especially with respect to taxation.

Inadequate Infrastructure



Infrastructure is a key driver that enables investments and growth for the manufacturing sector. Basic infrastructure of road, rail, ports, industrial parks, water and power requires significant development and investment in the near term.

Labour reforms



Skill gap in the Indian workforce, recruiting the right workforce, and inadequate labour laws pose major constraints in hiring labour⁷.

Level of automation



With innovation and efficient manufacturing becoming an integral part of Indian industries, advanced automation is required in manufacturing and maintenance activities, which also needs to be brought in line with global norms.

Land reforms



Land acquisition has been one of the most significant constraints for development of industries and infrastructure. As per KPMG-CII Ease of doing business study, delays may increase the capital cost due to cost inflation and associated additional interest costs.

Complex tax structure



Multiple central and state level taxes lead to higher logistics and compliance costs, rendering exports and manufacturing non-competitive. Complex structure of taxes also increases the paperwork required for compliance. Delays and high taxes may cause a 5 to 10 per cent loss in business in India⁷. Also, lack of a setting off mechanism results in cascading effect on the taxes for the manufacturing sector.

6. World Bank. 2013. Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises. Washington, DC: World Bank Group.
7. KPMG Ease of Doing business report, KPMG and CII, May 2014

Key initiatives under 'Make in India'

Well aware of the challenges, the 'Make in India' campaign has launched several initiatives to address relevant concerns, and has made the following progress:

Infrastructure

As per NITI Ayog's directional framework released in 2015, the government plans to focus on the following five major areas of infrastructure in order to augment overall infrastructure, attract investments and facilitate overall growth.⁸

Railways, Roads, Sagarmala project (for ports and coastal development), Inland waterways, Housing for All by 2022.

Ease of Doing Business

Recognising the need, Invest India Agency has been set up to promote and facilitate investments.⁹ The government has also released a 98-point action plan for states and union territories, in which they were ranked on the basis of ease for investors to acquire land, get access to infrastructure, obtain clearances and pay taxes. FDI norms have also been eased for key sectors, including defence, insurance, railways infrastructure, etc.⁹

'Skill India'

'Skill India' seeks to provide institutional capacity to train a minimum of 300 million into skilled workforce by 2022 in the country. There is a total outlay of USD234 million for this programme, of which USD174 million is expected to be spent on skill training of 14 lakh youth, and another USD34 million has been earmarked for a special emphasis on recognition of prior learning¹⁰. Significant steps have already been taken by the government under this initiative, including the implementation of the Labour Laws Amendment Act in September 2015

Digital India

This initiative was undertaken to digitally empower society and provide impetus to the country's knowledge economy, with an outlay of USD 17.5 billion.¹¹ The 'Smart Cities' initiative is closely aligned to 'Digital India'. A total of 100 cities have been identified for the mission¹² with a combined outlay of nearly USD22.5 billion, in addition to the planned rejuvenation of 500 cities.

Taxation

An immediate concern for indigenous and foreign business houses and investors in India was the country's complex taxation regime. The Government of India has been working on reforming this regime as it looks to further its 'Make in India' initiative, and to simplify the process of doing business in India. One such reform is the introduction of GST to replace many of the existing indirect taxes. It has the potential to be one of the most significant reforms post-Independence.

For the 'Make in India' initiative to attain its goals, the implementation of GST is considered to be very crucial, as it could be transformational for the business ecosystem of the country.

8. NITI Ayog website, accessed on 3 December 2015

9. India soars high, KPMG, Jan 2016

10. Pradhan Mantri Kaushal Vikas Yojana, Press Information Bureau - <http://pib.nic.in/newsite/PrintRelease.aspx?relid=117547>.

11. 'Digital India' is to be A Game Changer for the Country, Press Information Bureau, Gol - 24 December 2014, <http://pib.nic.in/newsite/PrintRelease.aspx?relid=114054>.

12. Smart Cities Mission Statement & Guidelines, Ministry of Urban Development, Government of India, June 2015, <http://smartcities.gov.in/writereaddata/SmartCityGuidelines.pdf>

GST – Tax transformation to 'Make in India'

The framework of GST is characterised by a marked shift from the present origin-based taxation to that of consumption-based. GST is proposed to be levied on a wide base of goods and services and is likely to subsume a majority of the existing indirect taxes – excise duty, service tax, VAT, Central Sales Tax (CST), purchase tax, octroi, local body tax, etc. Only a handful of goods and services of public importance are expected to be outside its scope. The implementation of GST is likely to enable taxpayers to receive credit for taxes paid on all procurements for business, which is currently subject to restrictions. The regime is expected to have an equally conducive regulatory effect on Foreign Direct Investment (FDI), allowing foreign manufacturing companies to also be able to reap benefits and, thereby, steadily build confidence in investing in India. The transition to GST may change the way business is done in India, and is widely expected to boost the country's economy.

Getting organisations to be GST ready

While the central and state governments continue to take rapid strides in implementing GST, it is imperative for each company to utilise this interim period to make themselves GST ready. Assessment of the impact on various areas of business and the changes to be undertaken in existing processes to make an organisation GST efficient should be the focus over the next few months. Companies can form an internal team by assigning representatives across major functional areas such as sales, marketing, finance, IT, HR, etc. and understand what GST would mean for their business, followed by a detailed impact analysis in these areas.



Organisations may witness an impact of GST across their following functional areas:

Fiscal

As GST is expected to be a uniform percentage countrywide, it may have a different fiscal impact on several transactions vis-à-vis current state-wise VATs. Further, under GST the burden of tax is likely to be passed on from the state of origin to the state of consumption, thus resulting in lesser revenues for manufacturing-focused states.

Business processes

Companies may have to review their business processes to suit the new tax regime.

Accounting

As GST shall be creditable and realisable at net input GST and output GST on a quarterly basis for firms, greater accounting measures may be required to maintain the quarter's GST inflow and outflow, and its reconciliation.

IT systems

Firms may need to overhaul their IT systems in areas of master data, supply chain transactions and system design.

Marketing

There is a need for a differentiated marketing approach as products can be now sold across states without any additional taxes. Hence, greater sales and marketing efforts may be required to create increased product visibility.

Supply chain

Upstream supply chain

Under the new GST regime, companies shall be able to procure their materials from interstate suppliers without the extra burden of paying CST. Hence, the entire vendor base is likely to be restructured as companies shall base their procurement decisions solely on the basis of cost, quality and other functional factors, rather than taxation factors.

Downstream supply chain

Currently, companies have kept separate depots/warehouses/ Carrying and Forwarding Agents in each state to cater to dealer/distributors of the same state, which has resulted in great inefficiencies in the downstream supply chain network. Under the GST regime, these state boundaries shall cease to exist from the taxation perspective and companies shall be free to cater to their dealers from neighbouring state warehouse without any adverse tax impact.

However, serviceability is an important factor when it comes to distribution-centric industries, such as FMCG, and may have to be maintained or up-scaled to avoid compromising on customer service.

Product pricing

Due to changes in taxation, the overall pricing of products may change. As there shall be a differential tax percentage from the existing VAT and CST taxes, the final retail price is expected to change, and companies are likely to pass on revised taxation to the end customer.

Cash flows

As every transaction shall incur a GST, and the same shall get accumulated in an escrow account, more cash may be locked up at every transaction, affecting the cash flows of the company. Hence, businesses may need to quantify the cash impact and realign their working capital approaches.



Supply chain disruptions in a GST environment

We believe that there are certain imperatives which are to be looked at for each industry with respect to emerging trends in the supply chain industry, and how firms can gear up for the same, in tandem with the new tax regime. They are with respect to:



Warehouse locations

In the current scenario, a differential tax structure exists across state boundaries, and it is these central and state tax structures that define the warehouse locations. In a post GST scenario, logistics costs (and not tax considerations) are expected to drive the warehouse and distribution footprint.



Geography coverage

The post GST scenario calls for an entire secondary network redesign where one can choose an efficient route and inventory at each warehouse to serve demand centres. The decision of geographic coverage by each warehouse will be driven by supply chain cost and service levels, rather than tax.



Manufacturing locations

The manufacturing footprint is set to witness an overhaul with the onset of GST, as India is expected to move from an origin-based taxation system to that of a consumption-based.



Product-plant mapping

In a pre-GST scenario, organisations were manufacturing products at a plant location, which was also its demand centre owing to creditable VAT costs. In a post-GST scenario, the decision of product-plant mapping is likely to be driven by economies of scale.



Manufacturing architecture

The entire manufacturing architecture in terms of plants, product-plant allocation, and job work is set to witness a change in a post-GST scenario. Manufacturers may realise higher margins encouraged by efficiencies in procurement, warehouse, distribution, and manufacturing.



Supplier network

Under the new GST regime, companies shall be able to procure their materials from interstate suppliers without the extra burden of paying CST. Hence, the entire vendor base could be restructured as companies base their procurement decisions solely on the basis of cost, quality and other functional factors, rather than taxation factors.



Sectoral impact

GST is expected to have an impact on almost all sectors of the industry. However, certain sectors could be impacted more as compared to others. The transformation of the existing regime to GST can be considered as an opportunity for companies to revisit their supply chain approach and pursue a methodical restructure of their operating model. Following are key sectors that may be strongly affected by GST, with respect to the nature of their supply chain models:¹³

Pharmaceuticals



Current state: Many pharmaceutical companies have pan India presence owing to the Clearing and Forwarding Agent model of their supply chain. This model is applied to mitigate the CST cost applicable on interstate sale of goods, the input tax credit of which is not available at present.

Pain point: This structure creates procedural hassles in terms of non-availability of statutory forms on time, and the restriction on free movement of goods across different states. This has led to prolonged disputes with tax authorities in various states.

Under GST: With availability of input tax credit of IGST on interstate transactions, need for CFA in each state could be eliminated. This can help rationalize the distribution centers in the supply chain. As GST shall be applicable to branch transfers, the hassles of obtaining and issuing statutory forms could be done away with, thereby reducing litigations. However, planning around blocking of working capital may be required.

Further, companies may have to relook at their pricing policy from key perspectives, such as differential excise duty structure for active pharmaceutical ingredients and active formulations, and the current practice of MRP basis to levy tax.

FMCG



Current state: The model is similar to pharmaceutical companies, with depots across states to mitigate CST.

Pain point: Procurement of inputs is generally an interstate transaction, leading to the CST levy, which in turn increases the cost of procurement, since diverse products that are manufactured in the sector.

Under GST: With availability of IGST credit on interstate procurements under GST, the industry can expect the procurement cost to come down and companies can rationalise their pricing policy.

Also, there is likely a rationalisation of number of depots, and an increased focus on supply chain cost in the sector.

13. <http://www.internationaltaxreview.com/Article/2808890/Search/GST-A-game-changer-for-industry>

Telecom



Current state: The supply chain network comprises of branch warehouses, normally spread in each state/circle of the telecom operator. Imported and indigenous goods transport is completely handled by the operator with 3PL companies. Stock transfers between branch warehouses are minimal.

The industry incurs significant cost in acquiring infrastructure facilities like towers and telecommunication equipment. The VAT applicable on such equipment is not available as input tax credit against the service tax payable on services provided by telecom operators.

Pain point: Dual taxation in certain states is a dampener for this fiercely competitive sector.

Under GST: With full input tax credit being proposed, operators can expect reduced cost of procurements. The current service tax payable on output services is expected to increase. There can be a regional warehouse concept implemented with one branch warehouse serving few circles. With telecom services being an important utility for the end customer, operators may need to look into their pricing, so as to avoid passing on the increased tax cost to the end customer. Clarity on differential tax rates for goods and services under GST is critical to this sector to avoid litigation.

Automotive



Current state: Several inputs used in manufacture of automobiles are subject to a lower VAT rate of 4 to 5 per cent, as compared to the VAT rate on the final product. Manufacturers prefer their ancillaries to be located in the same state so as to not only help manage the supply chain cost, but also in mitigating the extra cost of CST on which no input tax credit is available.

Pain point: This sector is subject to a variety of other levies, such as National Calamity Contingent Duty, Automobile cess, etc. which increases the cost to the customer.

Under GST: With full input tax credits on interstate transactions being made available under GST, automobile manufacturers can scout for alternative options for sourcing ancillaries, wherein the supply chain cost is not the key determinant. The additional levies can be subsumed under GST and should be of value to the end customer.

Real estate



Current state: This sector has been taxed rather aggressively, with multiple taxes being levied at various levels, such as service tax, VAT, stamp duty, etc.

Pain point: Non-availability of input tax credits has led to a cascading tax impact, which directly affects the end customer.

Under GST: The GST regime is expected to resolve many of the issues inherent in this sector in terms of multiple taxes and availability of tax credits. However, as this industry uses goods as well as services for providing the end product (typically known as works contract), it leads to double taxation (VAT and service tax) of some portion of the consideration. The industry should demand for removal of this anomaly by treating such contracts as service. Since stamp duty is not proposed to be subsumed under GST, this could lead to increased cost.

IT/ITes



Current state: This sector also suffers from the perils of double taxation, with packaged software being subject to service tax as well as VAT, as it thrives on exports.

Pain point: Service tax and VAT increases the cost to the customer as they are generally eligible to claim credit of either service tax or VAT, but not both. For exports, the present mechanism provided for refund of unutilised input tax credit used is fraught with anomalies and disputes, leading to long pending litigations, thereby increasing the cost of working capital.

Under GST: While the peril of dual taxation may not be relevant under GST, classification of software as goods or services would be important, which is yet to be clarified. For exports, the industry should demand a hassle free and assessee friendly refund mechanism.

Banking and Financial Services (BFS)



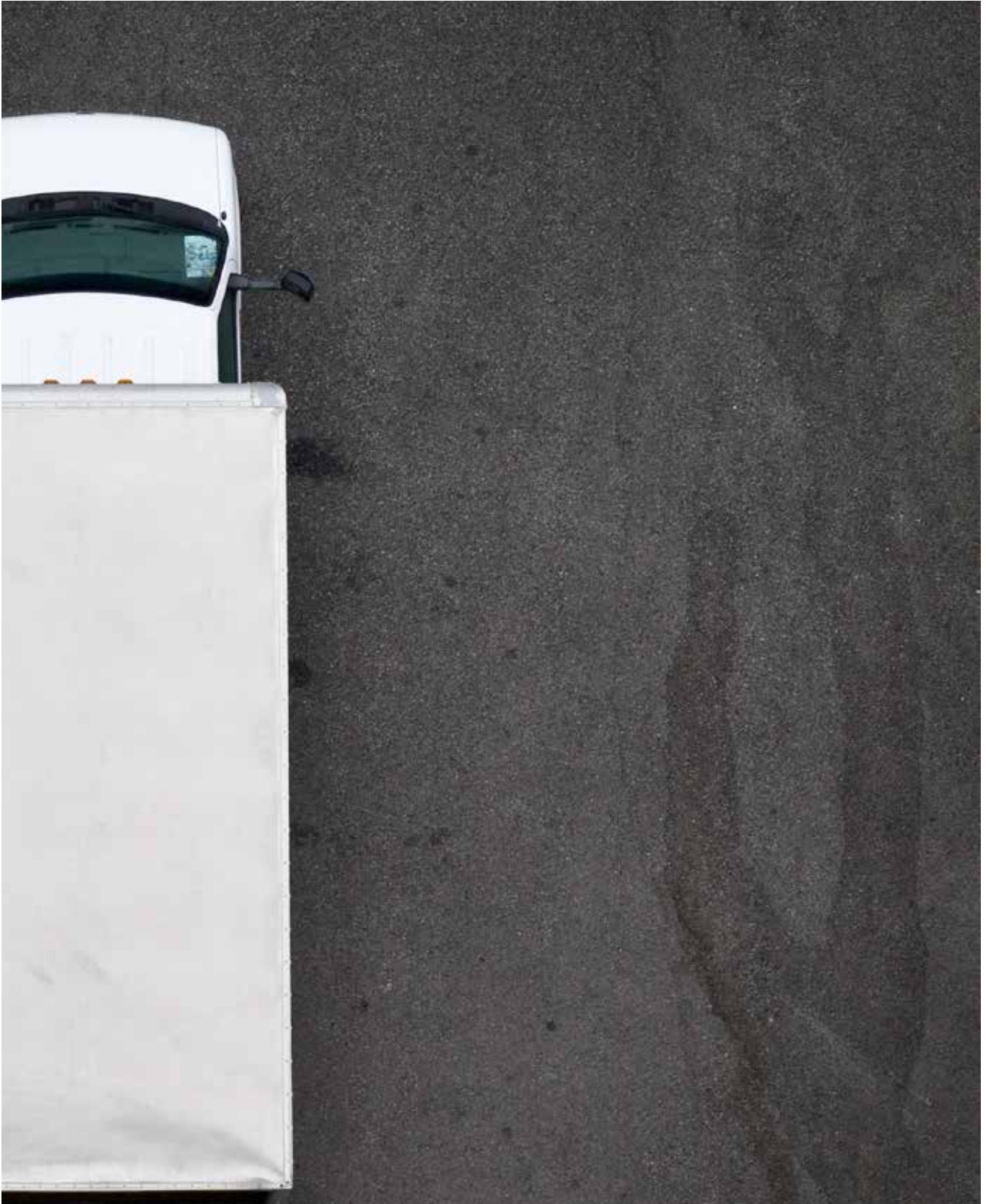
Current state: BFS was one of the first services to be brought under the ambit of service tax. Presently, service tax is applicable only on the fee income and charges. With respect to physical movement, the cash and documentation supply chain business is taxed similar to other sectors.

Pain point: The industry faces restriction on availability of VAT credits against service tax and also proportionate credit of service tax and excise duty upto 50 per cent. Hence, substantial input taxes continue to be a cost.

Under GST: With full availability of credit of input GST, this sector can expect lower costs on procurement. Clarity is required in this sector with respect to restricted credits where the activity of lending is kept out of GST. Cash and document supply chain will be benefited by rationalization of distribution network.

Conclusion

GST stands as one of the most significant tax reforms in India, and is likely to serve as a crucial enabler for the 'Make in India' campaign. With a importance of state boundaries and the cascading impact of taxes diminishing in making supply chain decisions it can serve as an opportunity for a company to carve a new and an efficient operating Model to give it that distinctive servicing advantage. The impact is also to vary with each sector and organization within it adopting its own blueprint to recast its supply chain. However one fact remains, for Make in India and Ease of Doing Business the time to buckle up is now.



KPMG in India contacts

Nitin Atroley

Partner and Head

Sales and Markets

T: + 91 124 307 4887

E: nitinatroley@kpmg.com

Ambarish Dasgupta

Partner and Head

Management Consulting

T: +91 33 4403 4095

E: ambarish@kpmg.com

S. V. Sukumar

Partner

Strategy and Operations

T: +91 22 3090 2490

E: sukumarsv@kpmg.com

Rajeev Singh

Partner

Strategy and Operations

T: +91 124 307 4000

E: rpsingh@kpmg.com

KPMG.com/in

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