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Impact of VAT And GST on Supply Chains of Garment Retail Sector

Om Prakash.C. and N. Thangavel

Abstract

The industry was eagerly awaiting an act from the government to simplify the Value Added Tax (VAT) assessment process across the different states in India. This VAT system has been recently introduced and not yet implemented to its full impact. When fully implemented, it would have long lasting consequences on the way the supply chain is being developed. The current form of VAT encourages retail trade within a single state, with significant implications on the location of warehouse and accordingly transportation costs.

The implementation of Goods and Service Tax (GST), will be a major milestone for the Indian Tax System, which will bring about changes in the way manufacturing, warehousing and distribution is carried out in India. Organizations have to restructure their supply chain strategy to overlook tax boundaries and will be able to position their warehouses and distribution networks, more focused on cost and time. To stay competitive, companies should be ready with their new supply chain strategy post GST - with details of an optimal network structure and the steps that needs to be taken to get there.

This research paper will analyze the impact of VAT and GST on Supply Chains of Garment Retail Sector.

Keywords: *VAT, GST, Supply chain, Retail Sector.*

Introduction

The retail industry in India is a $410 billion market and is expected to grow to more than $879 billion by 2018. Food and groceries account for 70% of the retailed items followed by textile and apparel at 7%. However, 95% of the retail sector is unorganized and fragmented. The textiles & apparel segment represents about 40% of the organized sector.

According to the study report, inadequate supply chain infrastructure, complex taxation laws, high levels of intermediaries, product proliferation and lack of supply chain visibility are a few supply chain challenges faced by the retail industry in India.

Inadequate supply chain infrastructure, complex taxation laws, high levels of intermediaries, product proliferation and lack of supply chain visibility are a few supply chain challenges faced by the retail industry in India. Though retail in India is making progress and is expected to grow more than $879 billion by 2018, the country loses $65 billion every year due to inefficient supply chain systems, says a study report.

Currently, the retail industry in India is a $410 billion market and is expected to grow to more than $879 billion by 2018. Food and groceries account for 70% of the retailed items followed by textile and apparel at 7%. However, 95% of the retail sector is unorganized and fragmented. The textiles & apparel segment represents about 40% of the organized sector. According to the study report, inadequate supply chain infrastructure, complex taxation laws, high levels of intermediaries, product proliferation and lack of supply chain visibility are a few supply chain challenges faced by the retail industry in India.

Improving supply chain infrastructure, implementation of goods and services tax (GST), reducing intermediaries, and adopting green supply chain practices are some of the recommendations of the report. Green supply chains involve integrating environmental thinking into the core operations of a company, starting from material sourcing to delivery to end-of-life recycling. It is expected that implementing green initiatives along a company's supply chain can raise productivity, enhance customer and supplier relations, support innovations, and enable growth.

Retail in India

The retail industry is facing challenges in the form of inadequate supply chain infrastructure and the complex taxation laws prevalent in the country. Investments in road infrastructure have not kept pace with the growth in road traffic, the report states. Only 20% of the roads are in good condition. The rail network is congested as freight moves on the same line as the passenger line.

India has been topping the AT Kearney's annual Global Retail Development Index (GRDI) for three consecutive years, thus presenting itself as an attractive market for retail investment. The sector is witnessing inflow of large domestic conglomerates, like Reliance, Bharti, AV Birla Group; and international conglomerates such as Wal-Mart, Marks & Spencer etc. In addition, large investment announcements have been made both in the front as well as back-end operations of the industry. About 35% to 40% of this would be spent in the rural retail - mainly dealing with logistics supporting urban retail.

The Indian retail market is the fifth largest retail destination globally. According to leading industry estimates, the Indian retail is estimated to grow from the US$ 412 billion in 2008 to US$ 483 billion by 2010 and $860 billion by 2018.(Source: Technopak Advisers)

Complex Tax Structure in India

India's tax regime has a significant impact on supply chain design. Transaction taxes (import/entry, manufacture and sale of goods and provision/receipt of services) have a direct and tangible impact on the cost of goods or services. The taxation structure in India is complex, with products typically being taxed twice: once by the central government and then by the respective state governments.

The Central Sales Tax (CST) effectively encouraged many companies to operate a warehouse in each state rather than pay CST while shipping to customers or stores across state boundaries.

Excise Duty, a structure of selective regional exemption, complicates logistics design by creating a skewed manufacturing footprint in India. Companies are likely to resort to deploying production operations in regions which offer exemptions to excise duty in spite of incurring higher logistics costs, time-to-market and working capital.

Further, the impact of varying Value Added Tax (VAT) structure in different states, customs exemptions in Special Economic Zones (SEZ), Service Tax and corporate tax make supply chain design and optimization all the more challenging.

As the tax and regulatory issues in India evolve, manufacturers and distributors must adjust their footprint and supply chain strategies, requiring greater flexibility and awareness than in most other markets.

The complex taxation environment in India skews the network footprint towards fiscally beneficial locations. All the different taxes and duties need to be modeled differently for a network optimization exercise. For instance, excise duty can be added to the modeled product cost with exempt locations incurring only input cost. On the other hand, income tax, levied on plant-level incomes, should be minimized separately in the overall objective function. Alternatively, income tax could be loaded on to production costs after careful examination of various plant-level cost elements.

In transportation and warehousing, CST, VAT and Octroi play an important role. Modeling CST, a tax on inter-state movement of goods, requires knowledge of source and destination locations and whether a lane is inter-state or intra-state. In order to overcome this tax, manufacturers typically move goods to a warehouse in each state as internal stock transfer and sales that take place are then shown as intra-state transactions. However, the phase-out of CST from March 31, 2010 has enabled shift to centralized distribution networks. Indian government has moved towards a uniform VAT across all states, ideally it should not have an impact on the future supply chain footprint.

Octroi, a tax levied on entry of goods into a town or city, forces manufacturers to locate warehouses outside city limits and move the goods into the city only when actual sales take place (to avoid paying taxes on inventory inside city limits). Thus, Octroi may lead to addition of a tier in the supply chain and consequently higher costs. However, Octroi has been phased out in most Indian states. Use of network modeling software like Supply Chain Guru can incorporate all the complexities of the tax structure and still suggest the most optimal network.

Impact of VAT

VAT system has been recently introduced and not yet implemented to its full impact. When fully implemented, it would have long lasting consequences on the way the supply chain is being developed. The current form of VAT encourages retail trade within a single state, with significant implications on the location of warehouse and accordingly transportation costs.

VAT structure can have major impact on Business. For example: Higher VAT pushed out luxury car buyers from Punjab to Chandigarh. The VAT levied in Chandigarh is 12.5% on the cost of the vehicle while in Punjab it is 13.75%. The 1.25% difference has enormous effect on Business.

Effect of GST on Network Models

Rationalization of excise duty rates and the expected implementation of Goods and Services Tax (GST) could significantly tilt the cost-benefit equation of the manufacturing location decision for certain firms. For instance, for products with an MRP of Rs 100 and raw material costs of Rs 40 the net excise payable (assumed at central GST rate of 8% and discounting recoverable excise paid on raw material) would be Rs.1.60. Factoring in inbound and outbound logistics costs, excise exemption benefits might be overridden by logistical efficiency criteria, compelling firms to rethink their manufacturing and distribution strategy.

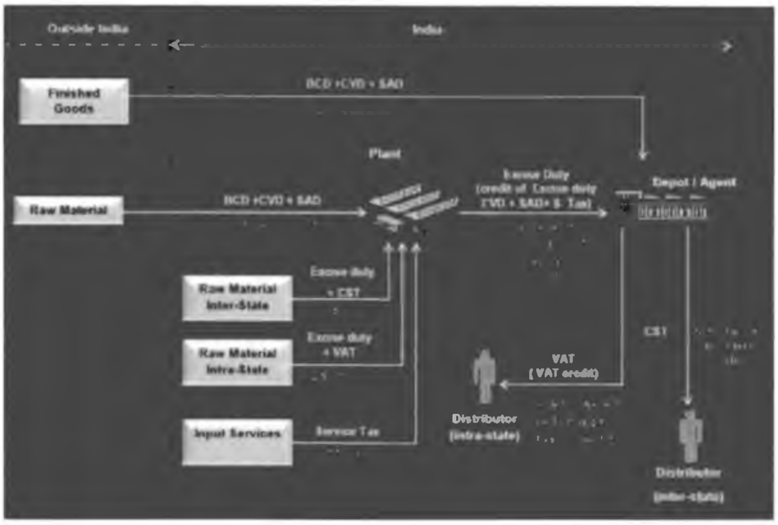

Fig.2: Mapping Supply Chain Network with Tax Structure Implications, (Source: Wordpress.com)

Implication for network design:

1. Distribution networks would shift towards the interstate sale model, eliminating the need for C&FAs and warehouses in each state.
2. Distribution networks would need to be redesigned to minimize total supply chain costs (primary & secondary logistics, warehousing and inventory holding costs) while maintaining service levels.

Getting ready for GST

Impact Assessment of GST must be studied on the following areas:

- Mapping the impact of GST on supply chain/business/margins
- Review of tax clauses of existing contracts and new contracts
- Identification of key decision areas
  - Indigenous procurement vs Imports
  - Manufacturing locations
  - Distributor/dealer networks and margins
  - Direct sales vs stock transfers
  - Warehouse & stocking points

Impact of GST on Supply Chain

To understand how Goods and Services tax (GST) will help companies optimize their supply-chain, one needs to understand a little bit taxation and the existing warehouse strategy.

Let us take the example of a company whose manufacturing facility is present in Delhi, and it moves its goods down to South India. As the company sells in South India, it has to transfer its manufactured goods across the States. According to the current taxation, if you're moving the goods from one State to another and selling it in the other State, then you're liable to pay the Central Sales Tax (CST). However, if you're transferring not for a sale but for a stock transfer, you don't need to pay the CST.

So, to avoid paying the CST, companies show the goods movement as a stock movement than a sale. But, to do this, they have to have a warehouse within the State where the goods are going to be transferred and stored. As a result, currently companies have warehouses within each State and show their goods movement as stock transfer than a sale. This essentially means that the current locations of warehouses are chosen to avoid the taxation, rather than to best service the customer.

For example, let us take the case of a city Hosur, which is a part of Tamil Nadu but it just 30km from Bangalore. So, geographically speaking, to service the customers in Hosur, the goods have to be shipped from the Bangalore warehouse. But unfortunately Hosur is a part of Tamil Nadu, which means the company has to pay the Central Sales tax (CST). So, instead of shipping the goods from the Bangalore warehouse, they are forced to have a warehouse in Chennai and ship from Chennai, which is 250km from Hosur.

With GST coming in, companies will be freed from this problem and they can setup their warehouses to optimize their costs and best service the customers. This is going to save considerable costs for companies and improve the servicing levels.

Staying Ahead

To be ahead of the pack and take benefits of the immediate savings post GST, companies need to act now. The implementation of GST (and abolition of Central Sales Tax(CST)), in 2010, is a major milestone for the Indian Tax System, which will bring about changes in the way manufacturing, warehousing and distribution is carried out in India. Organizations have to restructure their supply chain strategy to overlook tax boundaries and will be able to position their warehouses and distribution networks, more focused on cost and time. To stay competitive, companies should be ready with their new supply chain strategy post GST - with details of an optimal network structure and the steps that needs to be taken to get there.

Some of the key decisions required in order to re engineer the supply chains post GST will be:

- Own v/s Outsource decisions for services
- Intra state v/s Inter State procurement of goods
- Manufacturing and warehousing locations
- In-house v/s Contract Manufacturing.
- Direct selling v/s stock transfer

Supply chain experts and tax consultants of companies work in tandem to design an optimized network and provide guidelines of how to get there. The GST Network modeling is carried out in 3 stages: Analysis, Strategy & Execution.

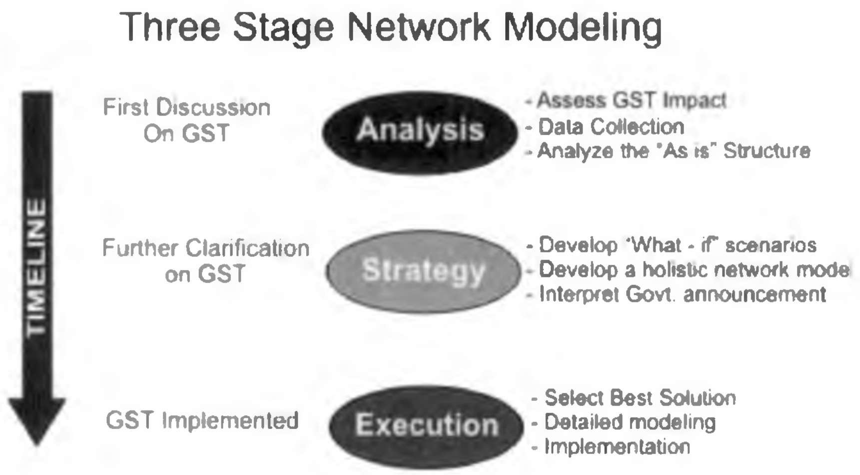

Fig.1. GST Network Modeling (Source: TCISCS)

The existing indirect tax regime has several characteristics which negatively impact supply chains. These range from irrecoverable taxes such as the Central Sales Tax (CST), complex documentation of inter State movement of goods, entry barriers at State borders resulting in long transportation times and imposition of local levies such as entry taxes and octroi upon physical entry of goods into designated areas. These characteristics add to the cost of doing business in India. On the other hand, the GST endeavors to foster a single market in India through a seamless and uniform application of the CGST and the SGST on all taxable supplies, throughout the supply chain.

Fundamentally, the GST moves away from origin based taxation to a destination based consumption tax. This means that all taxation will be based on where consumption of a good or a service takes place. Also, the taxable supplies under the GST will extend to all inter State movement of goods, including on branch or consignment transfers not resulting in a sale of goods. This has major implications for supply chains, particularly on classic hub and spoke arrangements of centralized manufacturing and disaggregated distribution. Further, the CGST, which was hitherto limited to the manufacturing stage, as an excise tax, will now be applicable throughout the chain subject of course to turnover thresholds, below which the tax will not apply at all.

These thresholds will be different for the CGST and the SGST respectively. Also, the point that the CST will be abolished/discontinued is equally important from a supply chain configuration standpoint. It is evident from the First Discussion Paper on the GST, released on 10th November, that the Centre will levy an Integrated GST (IGST), which would be the aggregate of the CGST and the SGST, on all inter-State supplies of taxable goods and services with appropriate provisions for taxation of branch or consignment transfers.

These changes pose challenges for companies as to how they might engineer their supply chains so as to be GST efficient. It is probably fair to suggest that the longer the supply chain, the more the tax points in the GST scheme of things and hence increased compliance costs. The challenge and the opportunity is to thus compress supply chains for GST efficiency while ensuring that the business objectives in and around supply chains are also met. The dual GST consequently affords companies significant opportunities for realignment of procurement, manufacturing and distribution / sales patterns and to engineer their supply chains on purely economic considerations as opposed to fiscal considerations. For this purpose, a comprehensive GST impact assessment would need to be carried out.

The time is therefore opportune for companies to gear up to face the challenges as also to seize the opportunities that the transition from the present tax system to the dual GST has thrown up.

Conclusion

Many taxes, including CST, will be subsumed into GST. GST will also replace a bevy of other levies like excise, sales tax, value-added tax, entertainment tax and luxury tax. Consequently, the need for having multiple warehouses will get diminished, though companies may choose to retain them for strategic reasons say, for being close to their customers.

A leading FMCG company has 23 warehouses across the country. It may not need more than five once the Goods and Services Tax, or GST, kicks in. It has begun consolidating its warehouses and has built a big one in a key North Indian state. Everything they have been doing in the pre-GST environment could change.

Right now, people try to ensure that goods come with as little tax as possible. Once GST comes, the timing and place of procurement will change. Currently, companies try to source their inputs from within a state as they get a set-off on the value added tax (VAT) charged by vendors. When they source from outside, the vendors charge CST, which cannot be set off. Under GST, companies will able to set off taxes paid on inputs, irrespective of where they are sourced from.

Consumer goods companies often run promotions where when you buy one, you get one free. In the current regime, if you give something free you can't claim credits on the tax paid on the inputs. Under GST, there will be no distinction among manufacturers, traders and service providers. At present, traders don't get credit for anything other than state VAT.

The new tax regime will compress the current supply chain structure and could thus water down logistics costs for companies across different sectors. Another possibility that could emerge is the concept of shared logistics infrastructure, such as warehouses, which would sharpen efficiencies.

Historically, tax structures have been a major platform for designing of supply chains. While procurement has been influenced by import duties and availability of input tax credits, distribution has been multi-tiered, influenced by the State boundaries due to CST implications. Now, supply chain designed purely on business parameters will unlock considerable values. Further, the Fourth Party Logistics (4PL) industry, which is in its early stages of growth in India, could also get a significant boost after the implementation of GST.

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Om Prakash. C, Associate Professor, CMR Institute of Management Studies, Kalyan Nagar, Bangalore.

Dr N. Thangavel Principal, Jeppiaar Engineering College, Rajiv Gandhi Salai, Chennai.