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SHORT TERM PAIN FOR LONG TERM GAIN

The landmark tax reform is positive for India

On the midnight of 30 June 2017, the much awaited Goods and Services Tax (GST) was launched by the Prime Minister of India, Narendra Modi. The GST will replace a labyrinth of local levies with a singular national code across all industries, rendering India an easier place to conduct business.

With this tax in place, the authorities hope to rein in tax evasion and reduce corruption, with the ultimate goal of upping tax receipts and increasing government revenue.

As with any new regulation, there will be short term disruption and teething issues. For the consumer, higher costs and business profiteering are key concerns while implementation and compliance (as expected) seem to be the main issues for companies.

The anti-profiteering clause however should ensure that most businesses would pass on the benefits of input tax credit to consumers and any inflationary pressure from higher effective tax on some good and services would be curbed.

In fact, the Confederation of Indian Industry (CII) has stated that input tax credit will curb inflation by avoiding tax-on-tax; experts believe its impact on inflation should be negligible, and at the margin, deflationary. Furthermore necessary food items such as grains and milk have been exempt from GST; prices for durables are expected to go up by only 1.2%[1].

From a business perspective, the impact will differ across industries. For example, within the real estate sector, the mass realty segment will likely get a boost as there is no GST for affordable housing.

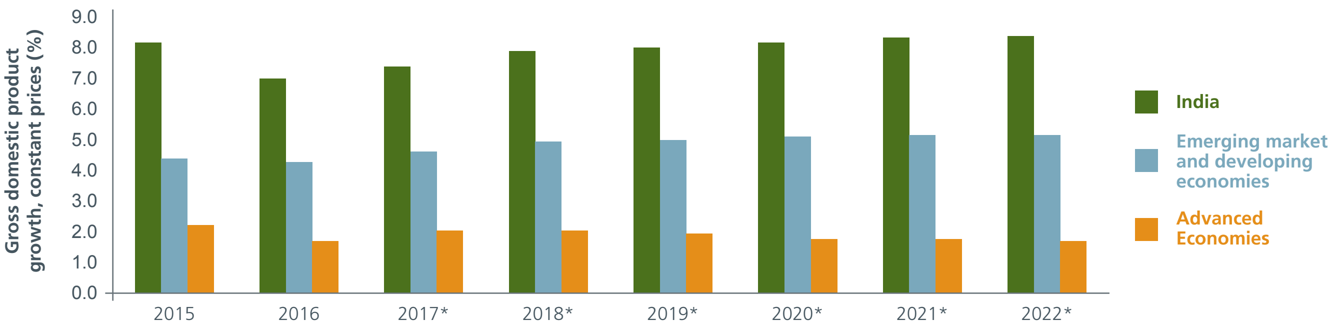
Developers will likely shift their focus to this segment which will likely help overcome the supply side constraints. Larger manufacturing players are also encouraged by the uniform tax as smaller, tax-evading competitors now have to align with the industry; this however may put some smaller less-efficient players out of business.

Separately, the Federation of Indian Export Organisations expressed concern that the GST could put businesses in a liquidity crunch as the input tax credit could only be received after actual goods are sold. There is also a risk of economic slowdown during the adjustment phase; businesses went on a de-stocking spree in the run up to the GST implementation date. But over the medium term, the International Monetary Fund[2] projects that the GST will enable India's GDP to grow over 8% (refer to Fig.1).

At a portfolio level, our investment team is conscious that some companies will go through a phase of adjustment and implementation which might upset near term earnings; but the process of normalisation will likely not linger beyond two-three quarters.

On a macro level the team believes the GST is positive for the business environment over the long term. This historic event is a boon for the incumbent administration as it not only strengthens India's fiscal position but also betters its international standing.

Fig.1. IMF projects India's GDP to grow over 8%



Source: IMF, World Economic Outlook Database, as at April 2017. *IMF estimates.

[1] "Impact of GST on consumer durables: Good news, despite highest tax slab of 28%, burden may not be passed on to consumer" Financial Express, as at 2 July 2017. The tax rate for the sector was around 25-27 per cent, which has been hiked to 28 per cent under GST. [2] Tao Zhang, Deputy Managing Director, International Monetary Fund, as at 28 April 2017.

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