VONTOBEL

Progress in India

September 2016

The Goods and Services Tax (GST)

India, despite having enormous potential with a huge and young population, a vibrant democracy, and capitalist economy has failed to offer anywhere near a decent living standard for millions – with the UN estimating that 22% of India's 1.2 billion population lived on an income below $1.25 a day ($456/year) in 2015. This terrible figure is, believe it or not, a considerable improvement, with the poverty rate having fallen by half since 1990 – a testament to India's economic reforms. But India needs to create decades of growth to bring these hundreds of millions above the poverty line, let alone to prosper. To open up the economy to just some of its potential, the government needs to re-launch its stalled reform program. And the government looks to have done just that with the passing of the Goods and Services Tax Bill.

India's early stage of development offers tremendous potential for its people, economy, and companies turning opportunity into products, jobs and income. We see attractive long-term opportunities for demand growth across almost any product a typical consumer would ideally have, such as clean water, sufficient food, health care, a bank account with credit, infrastructure to travel on or to provide goods and services, and electricity – not to mention the desirables such as hair conditioner or a car.

Since independence 69 years ago, India's economic path has been challenged by a lack of education, infrastructure, capital, and economic development. Early economic policy was often more focused on the Russian model than the British or American. As a result, central planning led to a considerable misallocation of tax money and reams of controlling regulations which led to the term "The License Raj." This remarkably complex system of red tape and taxes faced by business sapped considerable energy from the economy.

In 1991, the economy reached a crisis point and under great pressure started its economic liberalization. The early reforms have been of great benefit, leading millions out of poverty. But the reforms stagnated with a number of governments unable to pull the political levers to make the further changes badly needed.

The reform process has taken a new lurch forward under the Modi-led BJP government. In August 2016, both the lower and upper houses of parliament voted for a new tax to help streamline the mess that Indians deal with daily. The Goods and Services Tax Bill (GST) is a new tax structure that will overhaul a large part of the current spaghetti mix of central and state taxes.

We see the GST as a long-term positive for India, with some of its benefits including:

1. Cutting out much of the double taxing – materials in goods produced often have been taxed, but this tax is part of the price that is taxed on sale – with the GST, the earlier tax can be reclaimed. This has potential to cut taxes paid by consumers.
2. Bringing part of India's large informal economy on the books – buyers can only claim a GST refund on their inputs if the seller issues an invoice.
3. Lower cost of business across state lines – currently goods shipped across state lines are taxed. So many manufacturers establish duplicate plants to avoid this tax.

The final tax rates have not yet been decided although debate has focused on creating a revenue neutral tax rate, around 20%.

At this stage we feel it is too early to gauge potential impact at the company level as we are not sure what the final rates will be, and furthermore, it is not clear how much of any savings would be passed through to customers as lower prices. Our investment approach is rooted in bottom-up analysis. As a result, any impact from positive changes in an economy, such as an eventual roll out of the GST in India, will be analyzed company by company and not with a top-down view.

One area of uncertainty worth mentioning is on tobacco, for our holding ITC. There is still uncertainty as to what the final tax rates will be for tobacco, with discussion of a higher GST rate of 40%. However, we anticipate the tax impact will work out relatively neutral. We remain conviction holders of ITC as we feel the government will not raise taxes on cigarettes too sharply as they are seeing a negative impact on tax receipts – as volume of cigarettes (that pay tax) are substituted by cigarette alternatives such as bidis (that pay little or no tax).

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As regards timing of the GST – legislation was passed by both the upper and lower houses in August but needed to be ratified by more than 50% of state legislatures. On September 1, this was achieved with Odisha becoming the sixteenth state to approve the Bill. The Bill was then signed by President Pranab Mukherjee on September 8. The government wants to introduce the GST by April 2017, although we would not be surprised if the tax was not rolled out until 2018 given the reviews and negotiations still to be completed.

We remain comfortable with our Indian holdings. We feel the current outlook for demand growth, and the regulatory environment, remains healthy for the long-term performance of the quality growth companies we look to invest in.

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