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Thematic

The Big Leap
to a formal economy

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Contents: The Big Leap; to a formal economy

The Big Leap

Formalizing India's informal economy

Propellants, opportunities and challenges

- **India is set to see a major overhaul in the trade structure in favor of the organized (formal) segment. With Goods and Services Tax (GST) implementation nearing reality and demonetization curbing the shadow economy, the organized segment is well poised to confront the alarming expansion of the unorganized (informal) segment.**
- **We believe this will present opportunities to take advantage of the shift in favor of organized names. However, our discussions with experts and sector participants highlight that the shift will be prompt for some sectors, gradual for others and challenging for a few.**
- **To play this theme, one has to carefully consider (a) probability/timing of the shift and (b) market share expansion potential, with narrowing price differential between organized and unorganized players.**

Government aiming to shift trade from unorganized to organized…

- Unorganized trade accounts for a significant proportion of India's economy. However, with rising per capita income and aspirational buying, the share of unorganized trade is gradually reducing. There is still a long way to go, though – various local and domestic institutions estimate that organized trade still accounts for 20-50% of GDP. Loopholes in the law and cash-based transactions in the informal sector have for long kept many businesses outside of the tax net.
- Against this backdrop, the Indian government has identified enhanced tax administration as an immediate priority, coming up with some crucial initiatives to curb the shadow economy and shift trade to the organized sector.
- We believe demonetization and GST – the biggest indirect tax reform (likely to be rolled out in CY17) – are the two key catalysts that could accelerate the shift toward organized economy.

….by employing technology and lowering threshold for tax exemption

- The shift will be primarily driven by better tax administration and compliance. The threshold limit for exemption from indirect taxes will be reduced to INR2m under GST from INR15m currently under excise. Also, the flow of GST credit in the entire value chain will be tracked using technology platforms (Goods and Services Tax Network, or GSTN).
- GSTN will facilitate bilateral validation of invoices, online integration of data and big data analytics, which will go a long way in addressing the loopholes in tax administration. Better compliance due to availability of input credit and overall reduction in tax rates will also discourage tax evasion.

The Big Leap

Formalizing India's informal economy

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[Please click here for Video Link]

Addressable market to expand for organized players in some sectors

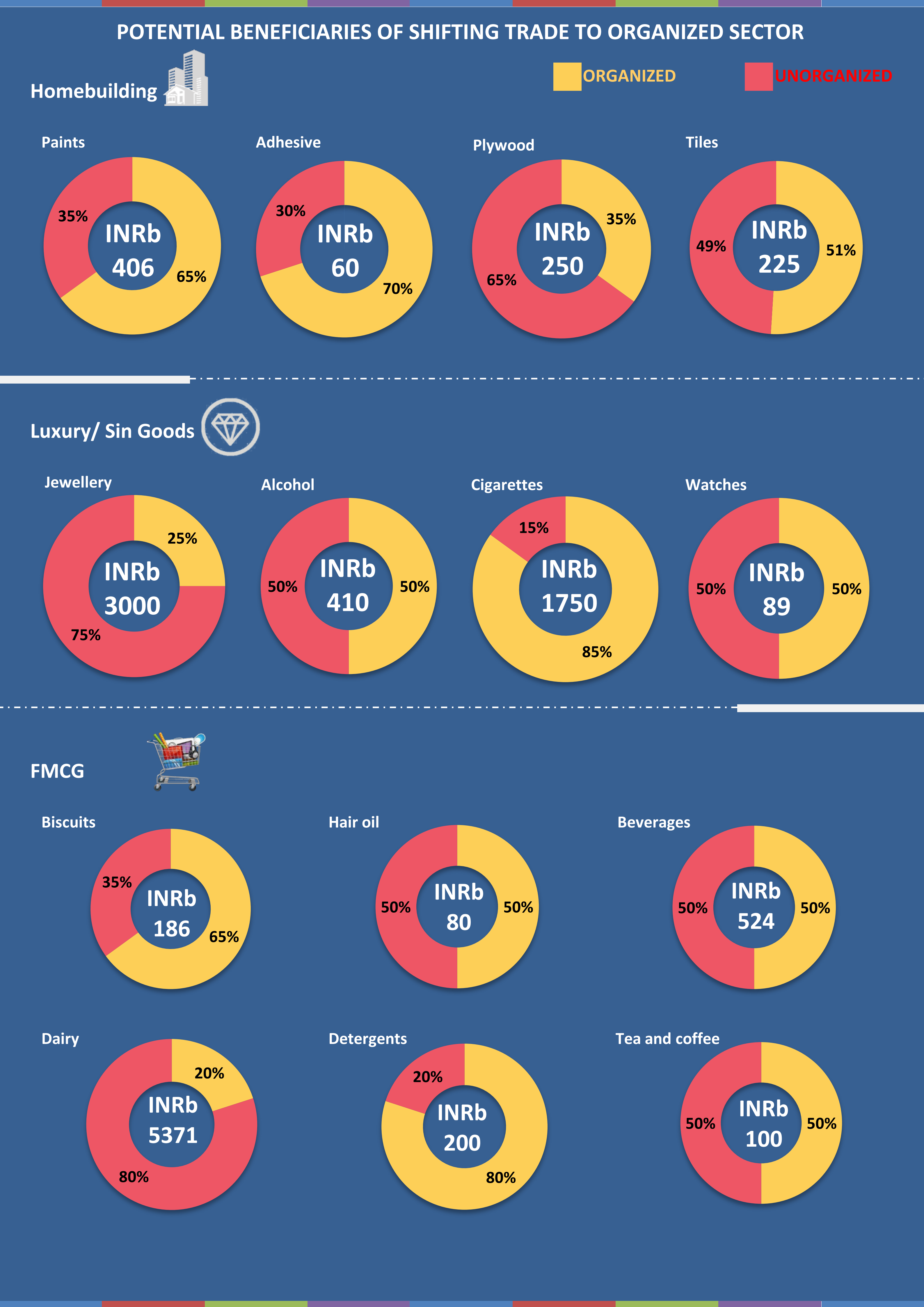
- The consumer, home building, light electricals, auto ancillaries (batteries, tyres), healthcare, logistics and metals segments are crowded with unorganized players. The shift away from unorganized trade is likely to benefit the current organized names, as tax arbitrage will help narrow the price differential between organized and unorganized players.

Potential beneficiaries of shift in trade to organized sector

Source: GSTN, MOSL

Probability and quantum of shift critical for portfolio decisions

- Our discussions with various experts and industry participants suggest that the transition to organized trade will be instantaneous for some sectors, gradual for others and challenging for a few.
- We believe that to play this theme, one has to carefully consider (a) the probability/timing of shift for sector participants from unorganized to organized and (b) the potential market share increase for the current listed organized players.
- The probability and timeframe for the shift primarily depend on the business supply chain that they currently work with, and the checks brought to curb the modality with which they circumvent the tax net.
- The potential addressable market size increase will primarily depend on the narrowing of the product price differential between the organized and unorganized players, while other factors like product portfolio, quality, brand appeal and distribution will determine the magnitude of benefit to individual players.

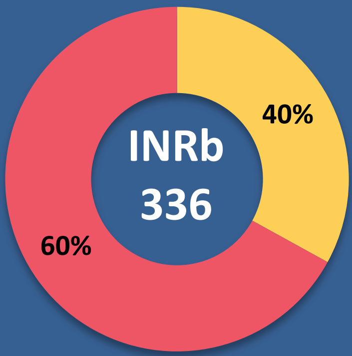

POTENTIAL BENEFICIARIES OF SHIFTING TRADE TO ORGANIZED SECTOR
ORGANIZED
UNORGANIZED
Homebuilding
Paints
INRb 406
35%
65%
Adhesive
INRb 60
30%
70%
Plywood
INRb 250
35%
65%
Tiles
INRb 225
49%
51%
Luxury/ Sin Goods
Jewellery
INRb 3000
25%
75%
Alcohol
INRb 410
50%
50%
Cigarettes
INRb 1750
15%
85%
Watches
INRb 89
50%
50%
FMCG
Biscuits
INRb 186
35%
65%
Hair oil
INRb 80
50%
50%
Beverages
INRb 524
50%
50%
Dairy
INRb 5371
20%
80%
Detergents
INRb 200
20%
80%
Tea and coffee
INRb 100
50%
50%

POTENTIAL BENEFICIARIES OF SHIFTING TRADE TO ORGANIZED SECTOR

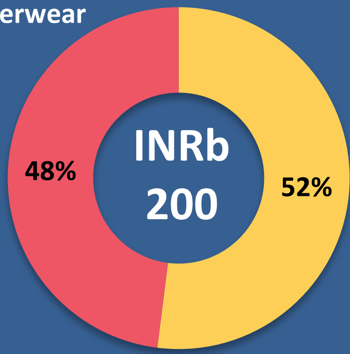
ORGANIZED UNORGANIZED

Consumer Others 

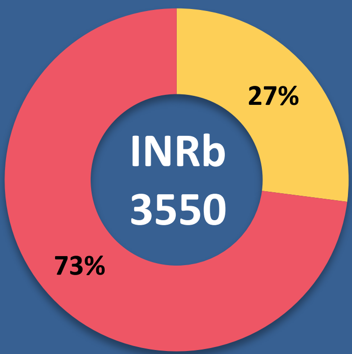
Footwear



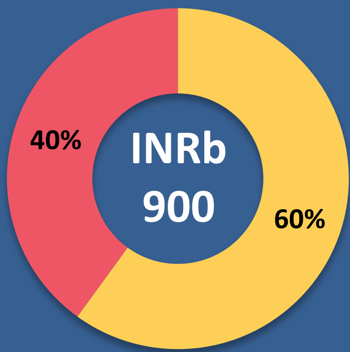
Garments-innerwear



Apparel

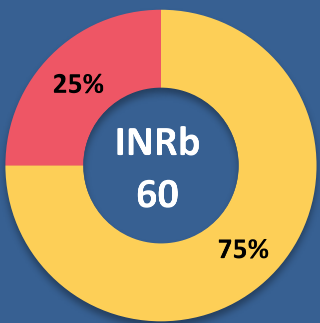


Plastic

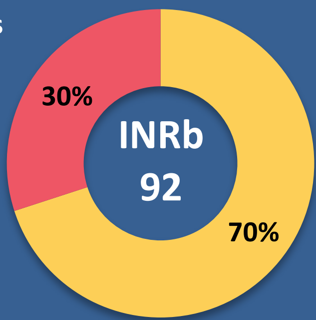


Light Electricals 

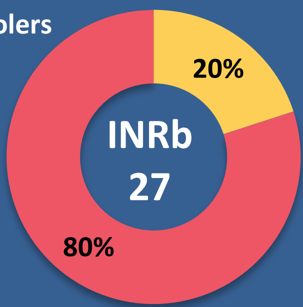
Fans



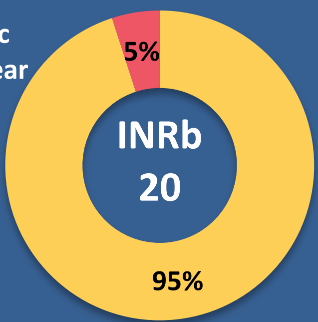
Pumps



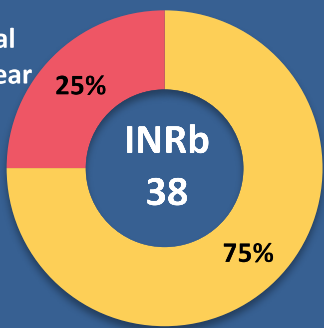
Air coolers



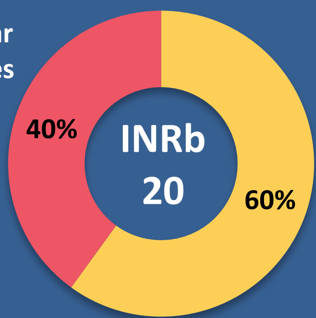
Domestic switchgear



Industrial switchgear



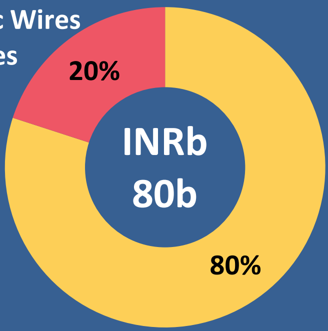
Modular switches



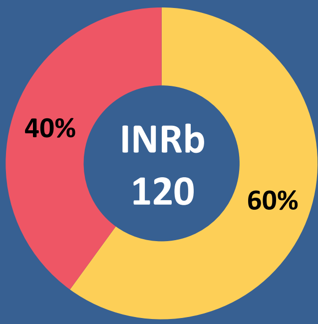
POTENTIAL BENEFICIARIES OF SHIFTING TRADE TO ORGANIZED SECTOR

ORGANIZED UNORGANIZED

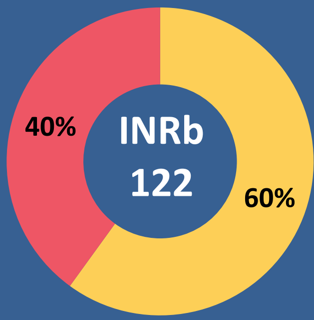
Domestic Wires and cables



Industrial cables

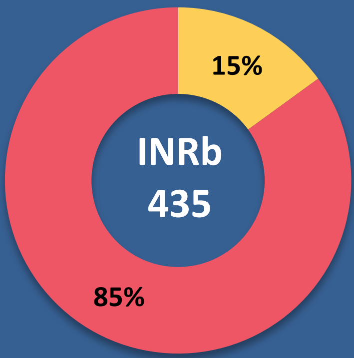


Electrical lighting

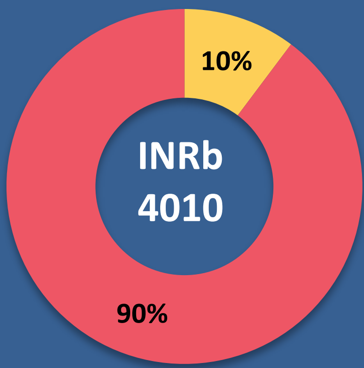


Healthcare

Diagnostic

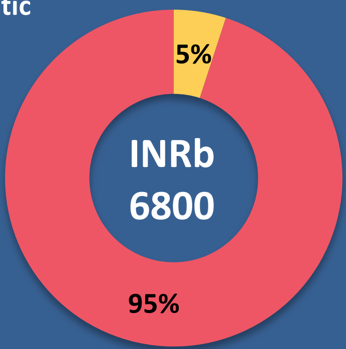


Hospitals



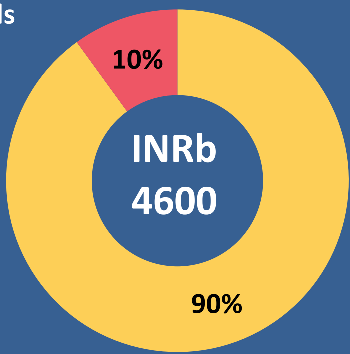
Logistics

Logistic



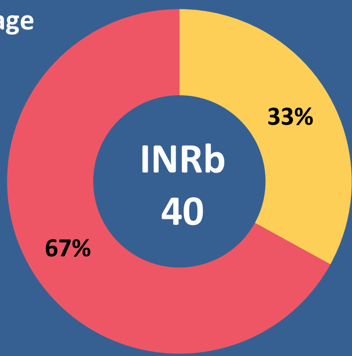
Metals

Metals



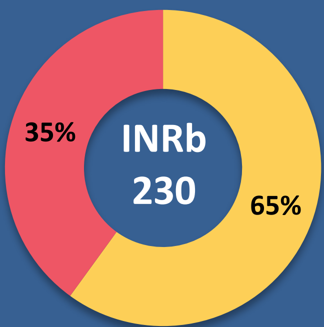
Luggage

Luggage

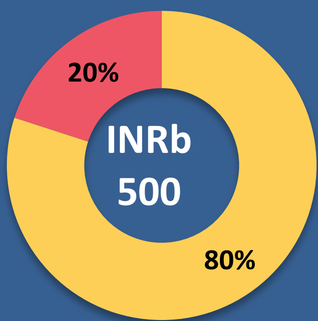


Auto

Batteries



Tyre



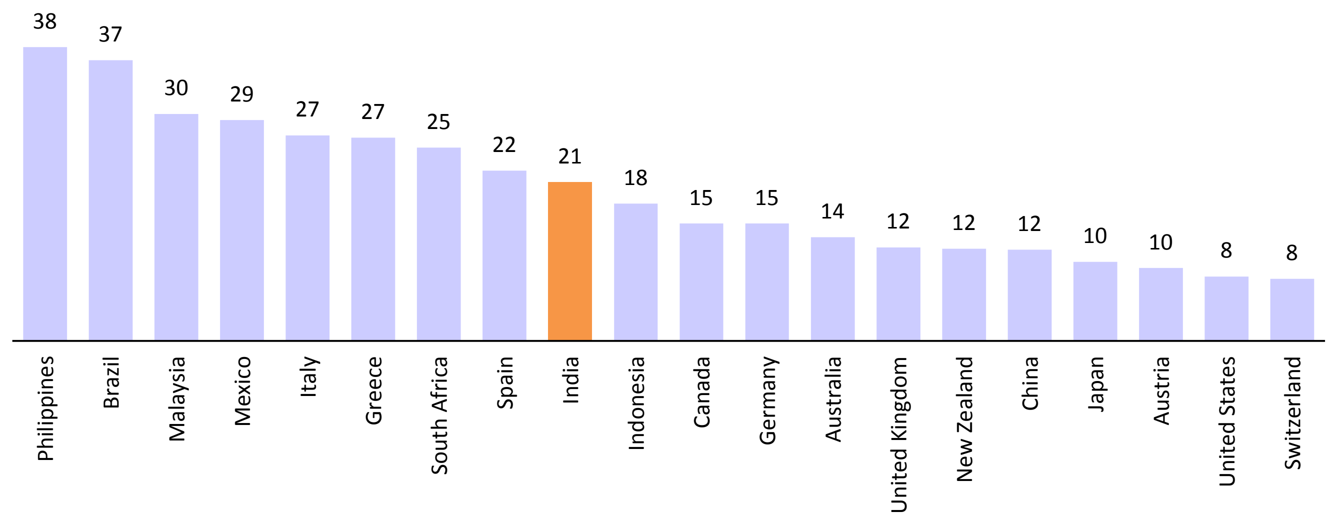
Unorganized market – global and Indian perspective

Unorganized market has existed for years

Shadow economies and unorganized sectors have been in existence not only in India but also globally for a long period of time. While it is very difficult to gauge their size, many domestic and global agencies have used different methodologies and definitions to arrive at their estimates. Although most of these studies are quite dated, they give a perspective that the unorganized markets are fairly large.

- The World Bank in its paper on shadow economies in 2010 derived that:
  - Shadow economy for all countries investigated had reached a remarkably large size, with a weighted/unweighted average value of 17.2%/33.1% of official GDP.
  - There is a clear downward trend in the size of shadow economy over time.
  - The size of shadow economy in India was 21.7% of GDP in 2005, which declined to 20.7% in 2007.

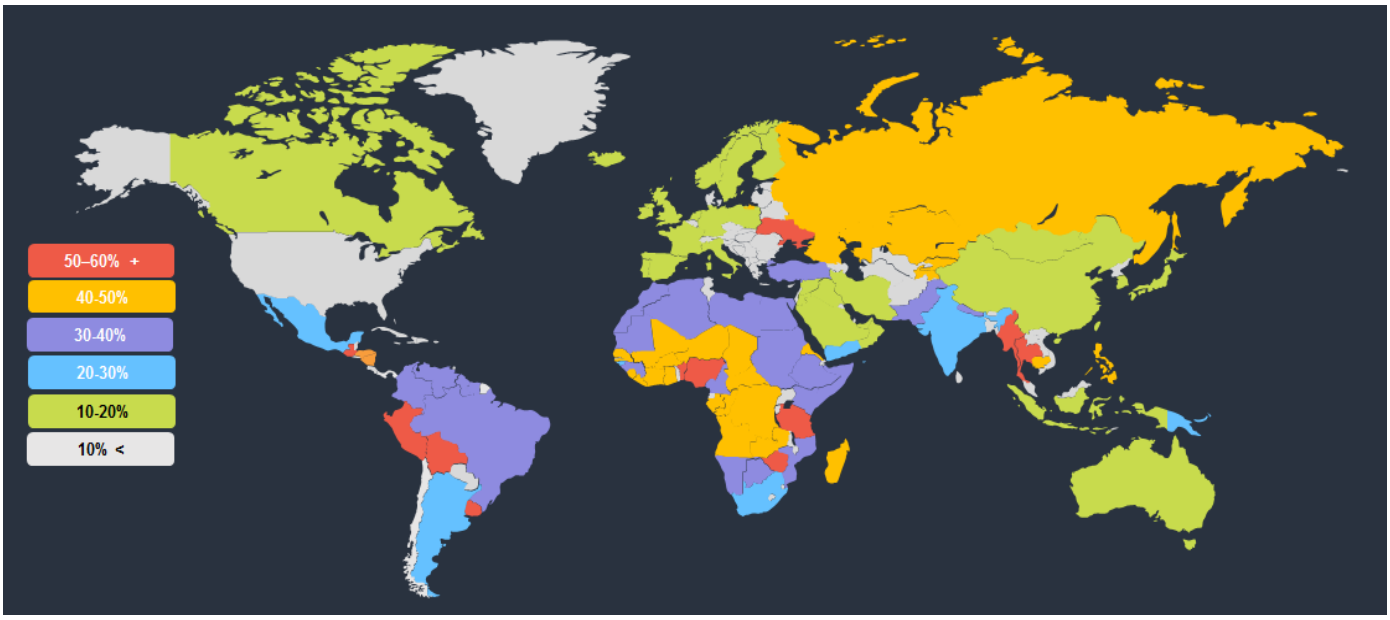
Exhibit 1: Shadow economies around the world (% of GDP)



2007 estimates

Source: World bank paper 5356, MOSL

Exhibit 2: Shadow economies present around the world

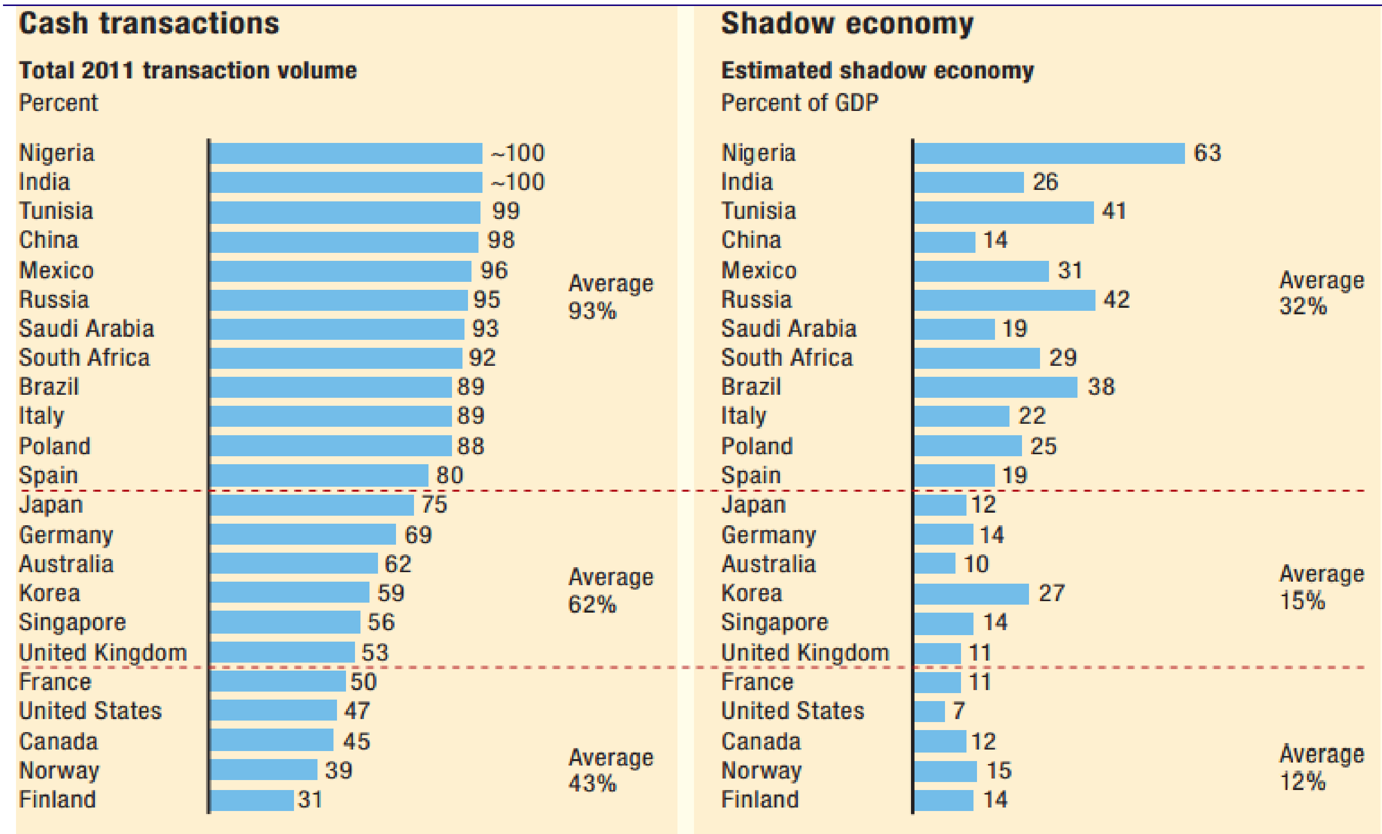


Source: World bank paper 5356, MOSL

High cash transactions allow shadow economy to prosper

- McKinsey's study in 2013 highlighted that the prevalence of cash-based transactions often allows an "informal" or "shadow" economy – one that is not taxed, monitored by the government – to grow or dominate. International comparisons show a clear correlation between the cash usage in the economy and the size of shadow economy.

Exhibit 3: High correlation between cash transactions and shadow economy



Source: Mckinsey, MOSL

India's unorganized sector is very large

- The National Commission for Enterprise in the Unorganized Sector (NCEUIS) in its second working paper in 2008 had estimated that:
  - Total GVA of unorganized sector in India stood at INR12t as at FY05.
  - 50.6% of GDP in FY05 was unorganized. The unorganized sector accounted for 75.1% of trade and 63.4% of real estate transactions.

Exhibit 4: Estimated unorganized markets in certain sectors (INR b)

Particulars	Unorganized Sector		Total Industry		% unorganized	
	FY00	FY05	FY00	FY05	FY00	FY05
Private Household & Extra territorial Organization	30	51	38	53	80.1%	95.3%
Agriculture	4,311	4,564	4,465	4,831	96.6%	94.5%
Trade	1,793	2,570	2,319	3,423	77.3%	75.1%
Other Community, Social & Personal Services	235	335	385	482	61.0%	69.4%
Real estate, Renting & Business Services	988	1,163	1,279	1,832	77.2%	63.4%
Hotels & Restaurants	125	163	223	320	56.2%	50.8%
Construction	456	720	1,020	1,554	44.7%	46.3%
Transport & Storage	764	1,074	1,334	2,417	57.3%	44.4%
Manufacturing	776	986	2,689	3,674	28.8%	26.8%
Health & Social Work	60	106	276	458	21.8%	23.2%
Mining	125	94	416	523	30.0%	18.0%
Education	96	113	696	918	13.8%	12.3%
Banking, Finance & Insurance	79	130	1,057	1,399	7.4%	9.3%
Electricity, Gas & Water	18	16	445	545	4.0%	3.0%
Public Administration & Defense	45	6	1,224	1,460	3.6%	0.4%
Total	**9,900**	**12,091**	**17,865**	**23,891**	**55.4%**	**50.6%**

GDP estimate at 1999-2000 prices and growth rates

Source: NCEUIS, MOSL

- According to the National Sample Survey Office (NSSO) survey conducted in 2008, 86% of total employment was in the informal sector in FY05. Of this, 64% was in agriculture, 15.3% in industries and 20.6% in services sector. Around 80% of the informal sector workers were from rural areas.

Exhibit 5: Employment in informal sector high

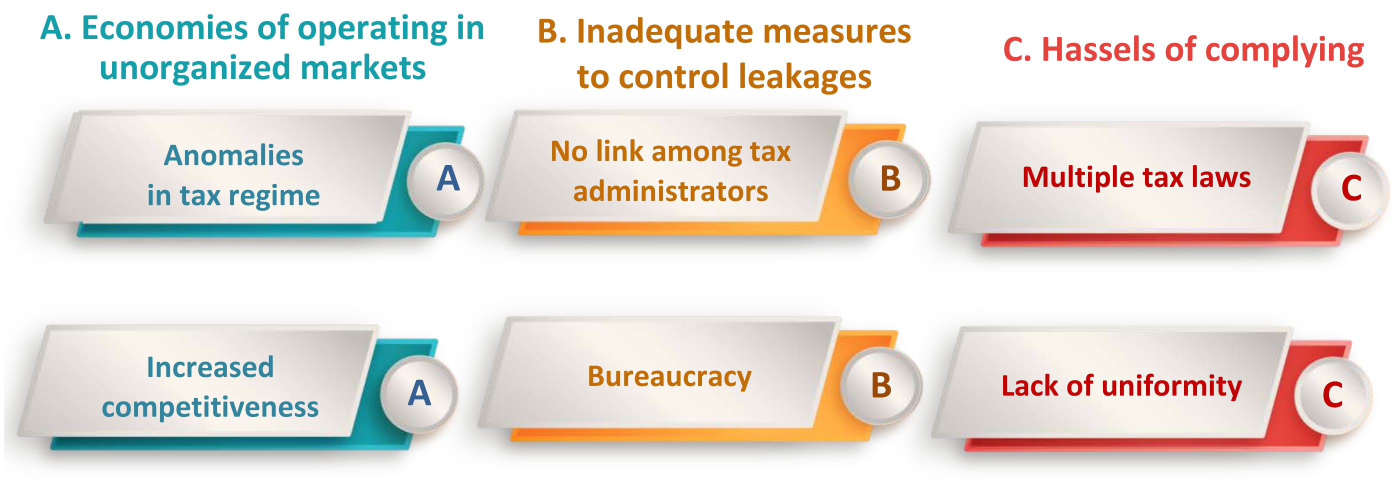
Particulars	Informal		Formal		Total	
	No.	%	No.	%	No.	%
Agriculture	252.8	64.0	6.1	9.7	258.9	56.6
Industry	60.3	15.3	25.4	40.6	85.7	18.7
Services	81.4	20.7	31.1	49.7	112.5	24.7
Total	**394.5**	**100.0**	**62.6**	**100.0**	**457.1**	**100.0**

Source: NCEUIS, MOSL

Why unorganized market exists in India?

- **Unorganized players enjoy significant economies of operation as they incur less compliance cost relative to their organized counterparts. Further, the lack of adequate control, along with bureaucracy/corruption, has made their survival easy. Such markets also get encouragement as entities avoid being part of organized sector due to hassles of complying with multiple tax structures.**

Factors facilitating unorganized markets in India



Source: MOSL

Unorganized players gain price competitiveness by skirting the tax net and passing the benefits (either partially or fully) to the consumer.

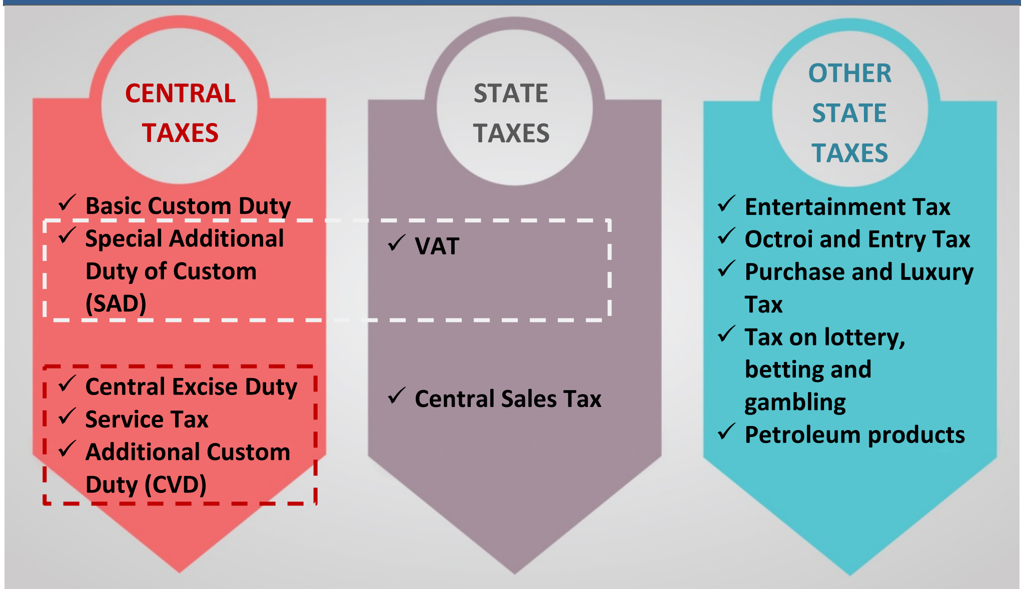
Economies of operation in unorganized markets

The current indirect tax regime in India is quite complex since the constitution provides autonomy to both the central and state governments to levy taxes at different incidences in the same value chain. This creates a lot of anomalies. People thus find it more beneficial to remain outside the organized chain.

- **Anomalies in tax regime**: In the current tax regime, there exist various anomalies (e.g. unavailability of input credits, taxes on output are higher than on inputs) incentivizing businesses to benefit by breaking the value chain.
  - **Unavailability of input credit:** Taxes paid under one statute are not allowed to be set off against taxes paid under other statute. Hence, an entity not able to claim the input credit is incentivized to remain outside the organized value chain. Few examples:
    - Input credit is not allowed for CST paid on inter-state movement of goods.
    - Excise duty paid on manufacturing and service tax paid on rendering of service are not allowed to be set off against VAT paid on the sale of goods and vice-versa.
    - Taxes paid under certain state level taxes cannot be used as an input credit against taxes paid to same and different state like entertainment tax, octroi and entry tax.

CENVAT available only if tax paid under the same statute

Limitations on utilization of input credit in current multi-layered tax regime



- - - - - CENVAT credit available

Source: MOSL

- **Taxes on output much higher than input:** Under the current VAT structure, inputs for many industries are exempted or taxed at a lower rate of 4%, while output is taxed at a base VAT of 12.5%. Such a big gap between input and output rates provides incentives to manufacturers for not reporting sales (substantial part of the tax is paid at this stage).

Tax arbitrage reduces cost, increases competitiveness for unorganized players

- **Increased competitiveness for unorganized players:** SMEs are generally at a cost disadvantage of working with a lower scale. Operating in the unorganized market leads to skirting of indirect taxes (e.g. excise/ VAT/service tax). The benefit is usually passed on (either partially or wholly) to consumers to offer an enhanced value proposition. This increases the competitiveness of unorganized players. Further, unorganized players (unlike organized counterparts) do not declare their profits, and hence also save on direct tax levy (@34% of profits), which flows directly to their retained earnings.

Exhibit 6: Taxes add significantly to cost in organized value chain

Particulars	Amount	Input credit available
Raw material	100.0	
Excise duty (12.5%)	**12.5**	**Yes**
Total Amount paid by manufacturer	**112.5**	
Cost for Manufacturer	**100.0**	
Value addition and profit	25.0	
Selling price of manufacturer	125.0	
Excise duty (12.5%)	**15.6**	**No**
VAT on selling price (4%)	**5.6**	**Yes**
Total Amount paid by trader1	146.3	
Cost for Trader 1	140.6	
Profit	7.0	
VAT on selling price (4%)	**5.9**	**No**
Final Price to the consumer	**153.5**	

Source: MOSL

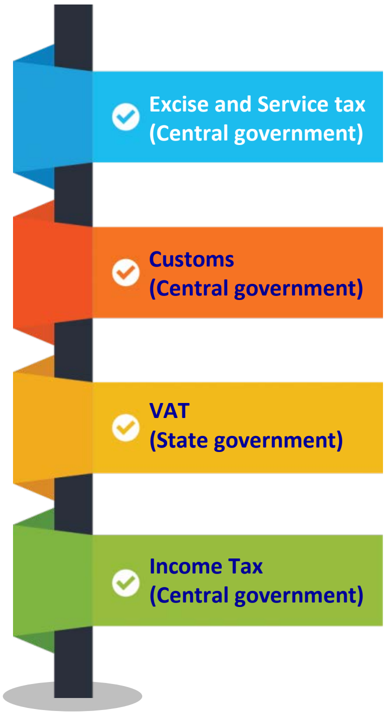
Exhibit 7: Tax evasion makes customers cost cheaper

Particulars	Amount
Raw material	100
Excise duty	-
Total Amount paid by manufacturer	**100**
Cost for Manufacturer	**100**
Value addition and profit	25
Selling price of manufacturer	125
Excise duty	-
VAT on selling price	-
Total Amount paid by trader 1	125
Cost for Trader 1	**125**
Profit	**6.3**
VAT on selling price	-
Final Price to the consumer	**131**

Source: MOSL

Inadequate measures to control leakages

The current government data collection mechanism is not much efficient as authorities (many state/central governments are involved) are not able to reconcile and share data with each other. Some of government bodies still operate on manual systems. This facilitates human intervention and thus corruption. These shortcomings help businesses to evade taxes and operate in the unorganized sector with minimal fear of getting caught.



- **No link among tax regulators:** Various indirect taxes are levied on the sale of goods/service, in addition to direct tax payable on profits. These taxes are levied by various government departments depending on the type of transaction. There is no homogeneity in collection of data by various departments. Thus, there is no trail of transactions when goods move from one tax administration to another, providing an opportunity to tax evaders. For example:
  - Inter-state purchase of goods by an entity may not be easily reconciled with the aggregate sales made by different sellers located outside the state.
  - Inter-state sale of goods made by entity may not be easily reconciled with the aggregate purchases made by different purchasers located outside the state.
  - To claim an input credit, an entity needs to produce the tax invoice. There is no system of bilateral validation to ensure that the duty so claimed as input credit has been duly discharged by the vendor.
  - Revenues reported under VAT/CST to different state governments may not add to the aggregate revenue reported by the entity to the income tax department.
- **Bureaucracy:** There is high manual intervention/discretion in the current indirect tax administration, which provides an opportunity for businesses to fare any objections which arise on opening of a tax scrutiny.

Hassles of compliance

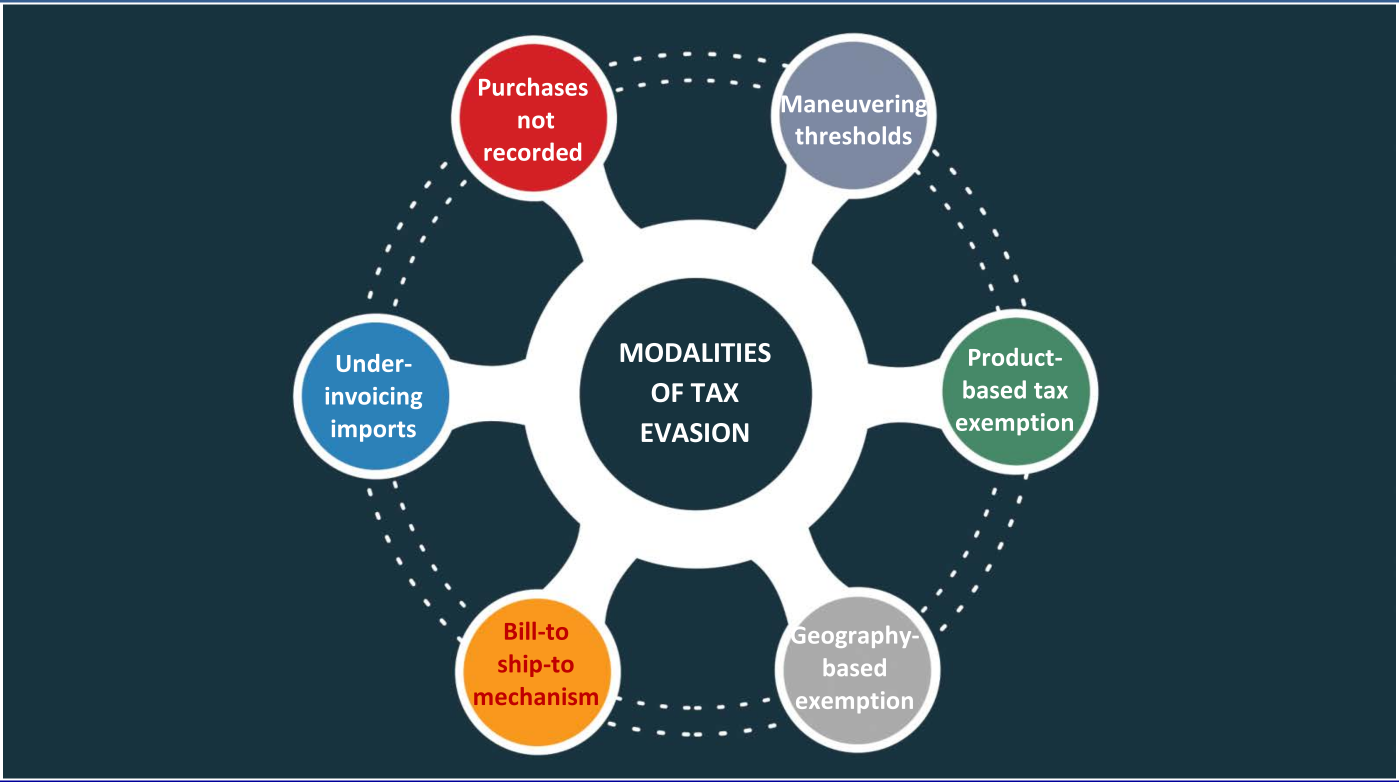
Under the current regime the entities are subject to multiple tax laws and further there is lack of uniformity in same laws across different states. This leads to significant hassles for businesses to operate in the organized structure.

- **Multiple tax laws:** A federal structure of government, where both states and the center have separate taxing powers, leads to higher compliance requirements. To be fully compliant in the current indirect tax regime in India, one may need to register with various departments (excise, VAT, service tax, etc.) for selling even a single product.
- **Lack of uniformity:** An entity with pan-India presence has to undergo multiple registrations in each state for the purpose of VAT. Also, VAT rules, regulations and product-wise rates vary from state to state. This leads to significant time and compliance cost.

Modalities of tax evasion

- **Our discussions with various sector participants and experts highlight that there are numerous ways in which tax evasion happens. Unorganized players today follow one or a combination of methods to circumvent taxes.**

Modalities of tax evasion

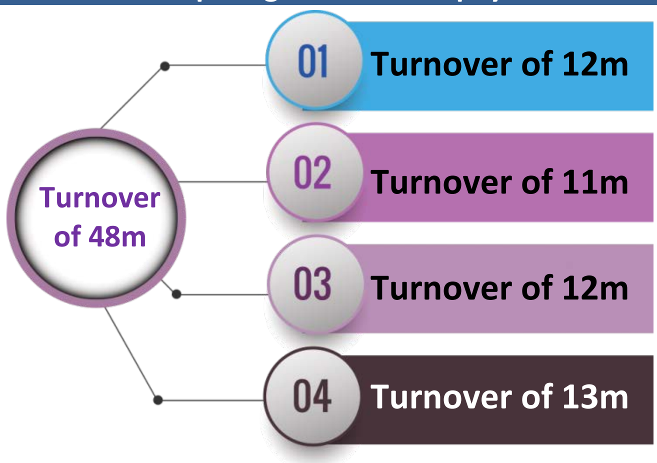


Source: MOSL

Splitting of revenue in different entities to circumvent levy of excise

- **Maneuvering thresholds:** Currently, the regulation allows a threshold of INR15m for levy of duty on manufacture of goods (excise). This is primarily provided to protect small-scale industries (SSI). However, in many instances, companies split their revenues in multiple entities to remain within the threshold limit. Even in some cases the turnover above the threshold limit is not reported to remain outside the levy of excise.

Splitting of turnover to escape registration and payment of excise



Source: MOSL

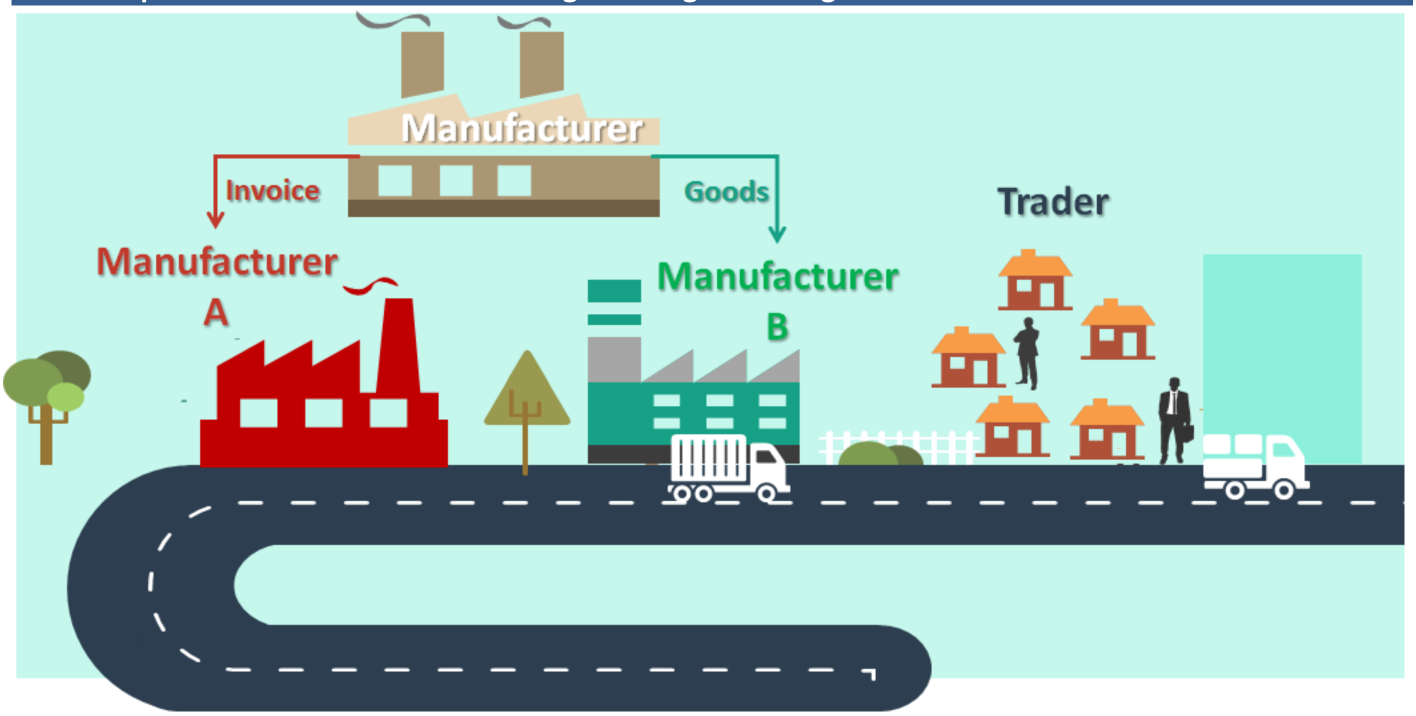
Exemptions break the value chain

- **Product-based exemptions:** Certain products (based on state preferences) are given exemptions for levy of state VAT. Even on inter-state sale of such goods, the duty is exempted. These goods are also used as primary inputs for the manufacture of taxable goods. However, due to duty differential between input and output goods, there are incentives to keep the purchase unrecorded. The subsequent value chain of such manufactured goods continues to form part of the unorganized sector. For example currently textile is exempted from levy of VAT in Karnataka while VAT is levied on readymade garment.
- **Geography-based exemptions:** Various entities are given indirect tax holiday for establishing the units in specific/backward areas. Our discussions with industry experts suggest that sales made by these entities are in many cases not recorded by the purchasers. The subsequent sales/manufacture of goods using such inputs are made through unorganized channels and indirect taxes are circumvented. Excise exemptions are currently available in Uttarakhand, Himachal Pradesh, north-eastern states, Jammu & Kashmir, Sikkim and Kutch etc. VAT/CST exemptions are available in Pondicherry and Dadra and Nagar Haveli etc.

"Bill to ship to" mechanism leads to loss of government while both consenting parties gain

- **"Bill-to ship-to" mechanism:** In some instances, two or more companies collaborate with each other, wherein one takes the physical delivery of goods, while the other just accounts for purchase of goods in its financial books for mutual benefit. Companies recording the transactions in their books claim the input tax credits and also gain by claiming additional expenditure to underplay taxable profits in their direct tax filings. On the other hand, companies getting the physical delivery of goods use it for unorganized manufacturing/distribution.

Bill-to ship-to mechanism leads to thriving of unorganized segment



Source: MOSL

- **Under-invoicing imports:** In certain sectors, goods are imported at invoice value that is lower than fair market value. This helps minimize indirect taxes on imports. Such imported goods then make way in the unorganized channels; invoice for sale of goods at nominal value is treated separately.

Non-recording of a valid transaction makes entire subsequent value chain unorganized

- **Unrecorded purchases/sales:** In many cases, the purchaser does not record the invoice issued in the financial books. This leads to sale of goods in cash to unorganized chains.

Besides these some of the sector participants also evade taxes by using the following methods:

- **Fraudulent bills/improper tax credits:** In the current system, there is unilateral validation to claim input credits. The purchaser claims input credit based on the invoice received. In some cases, the seller provides fraudulent invoices of goods, wherein it is shown that the necessary duty has been paid while selling the goods. However, no such duty is paid by the seller. This leads to loss of revenue for the exchequer.
- **Wrongful application of lower tax rates:** Currently, the tax rates on goods are decided based on the harmonized system on nomenclature (HSN). Entities, in many cases, try to classify their goods under the second best category (and not primary category), which is charged at a lower rate. This leads to a loss to the government exchequer on one hand and unfair competition with legitimate sector participants on the other.

Government's thrust to curb unorganized trade...

- **The Indian government is taking a number of initiatives to curb the shadow economy and shift trade from the unorganized to organized sector. Demonetization of high-value currency notes has created fear among unorganized players as transactions in this space were mostly cash-based and unaccounted.**
- **Besides, GST – the biggest indirect tax reform – is likely to be rolled out in CY17. It would help simplify/rationalize taxes, aiding the shift to organized trade. Better tax administration by reducing the threshold limits for exemption from indirect taxes and employing technology will be the key drivers of this shift.**
- **Even in the recent budget cash transactions of INR0.3m or more have been prohibited.**

Demonetization impact detrimental for unorganized players

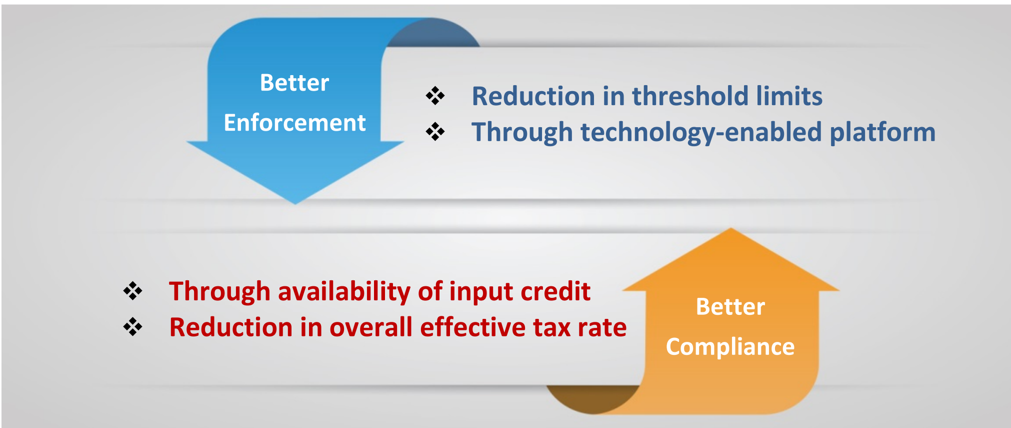
- The government has shown intent to break the grip of black money in the economy by demonetizing high-value currency notes. Although majority of the money found its way back to the banking system, we believe that it was a step in the right direction.
- Stern and proactive follow-up steps by the Tax Department will aggrieve evaders.

Better tax administration & compliance to shift trade from unorganized to organized

GST: GSTN platform and lowering thresholds to drive the big shift

- The indirect tax regime in India is set for a complete overhaul. We believe GST would simplify and rationalize taxes, shift trade from the unorganized to organized segment and improve efficiency in the system.
- The real value of GST would be in the area of tax governance, where a system plagued with a plethora of discretionary, ad-hoc taxes would move toward a ruled-based, transparent and stable tax regime. This would make the tax system fairer by ensuring 'neutrality' across players, products or services, locations and business cycles.
- This would be achieved by ensuring better compliance and enforcement, including (a) reducing the threshold limit for exemption from indirect taxes, (b) tracking the flow of GST credit in the entire value chain by using technology platforms, (c) ensuring availability of seamless input credit and (d) reducing the overall effective tax rates.

Measures that will lead to a shift to organized trade



Source: MOSL

Reduction in threshold limits

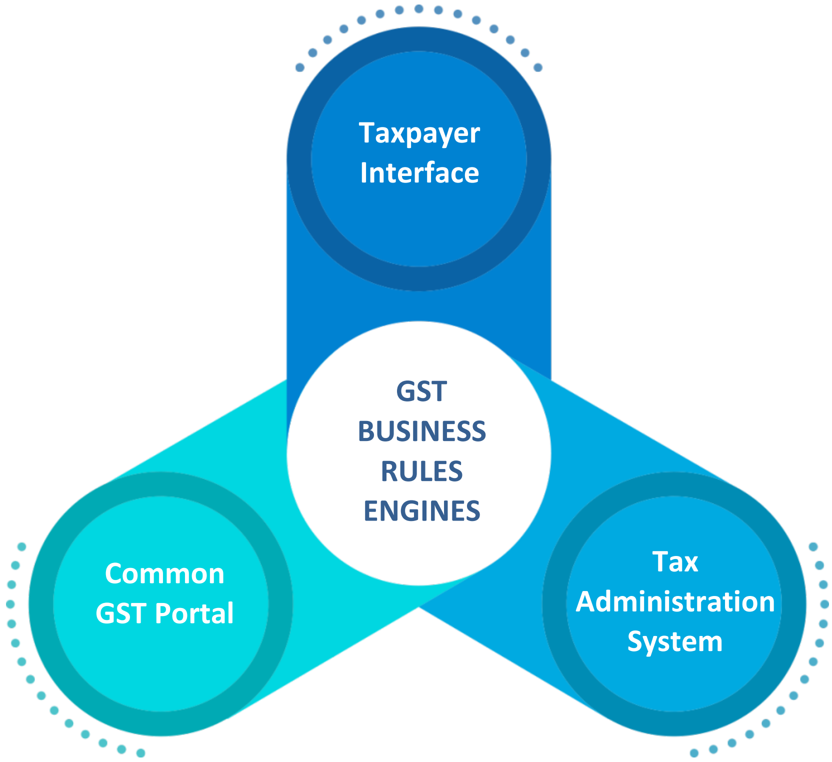
- As discussed earlier, SMEs are currently provided exemption from levy of excise (taxes on manufacture), provided their annual revenues remain within the threshold of INR15m. However, to benefit from these provisions, some companies split their revenues by operating under multiple names.
- Under GST, it is proposed to lower the exemption limit to INR2m. This will ensure that malpractices to circumvent taxes are kept under check.

Bilateral validation of invoices, online integration of data and big data analytics will go a long way in addressing the loopholes in tax administration.

GSTN: Automation in tax governance

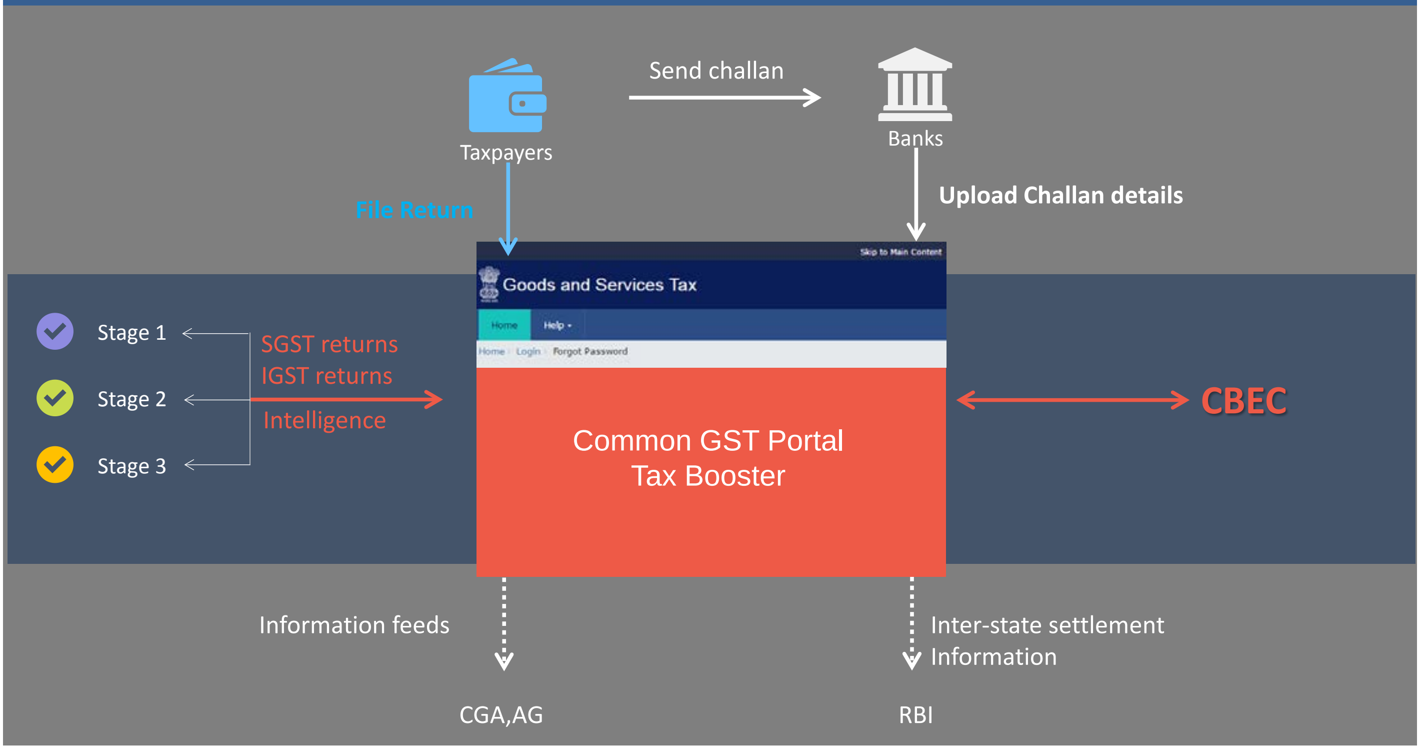
- Under GST, the government intends to employ technology to track end-to-end credit flow in the value chain. Bilateral validation of invoices, online integration of data and big data analytics will go a long way in addressing the loopholes in tax administration.
- A common GST IT portal operated by the Goods and Service Tax Network (GSTN) is being implemented for tax administration. Taxpayers will be required to register on the network and will get a unique 15-digit identification number to be quoted for every transaction.
- Registered dealers will have to file a GST return by providing invoice-wise disclosures of purchases/sales, quoting the GST number of counterparties. This will help maintain a trail of transactions, right from manufacturing to end-consumption. Any break in the supply chain will be an indication of tax evasion and invite scrutiny.
- This IT portal will result in homogenous data and seamless flow of information for all stakeholders. Each tax authority will have full flexibility in using this data for in-house automation, integration and enforcement.

GST portal – a common interface to all stakeholders



Source: GSTN, MOSL

GSTN: Information flow to become easier



Source: GSTN, MOSL

Bilateral validation: Invoice matching concept

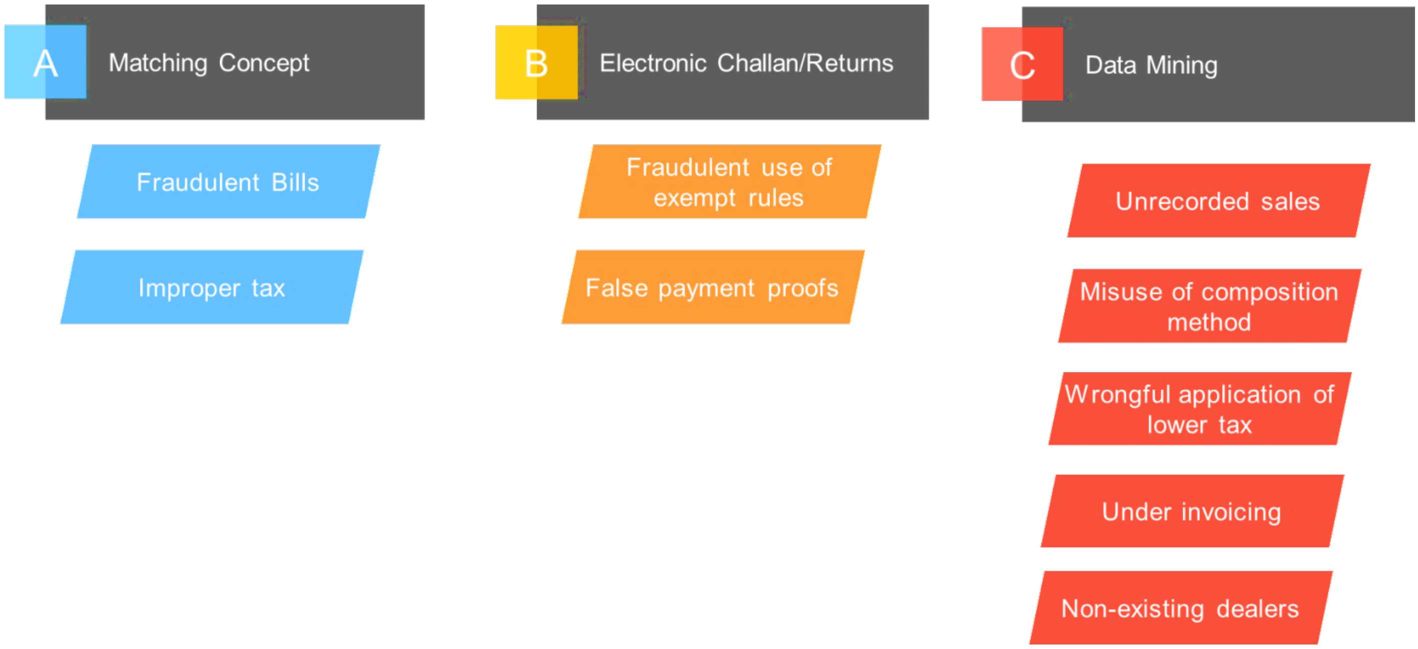
Bilateral validation will create a chain of traceable transactions

- Currently, there is unilateral validation of invoices, wherein sales and purchases are not matched. Input credit is allowed on presentation of invoice only.
- The automated system will allow input credit only after bilateral validation of data. Each party has to upload invoice-wise details of sales and purchases along with the GST number of the counterparty. This will thus create a chain of traceable transactions throughout the supply chain.
- The GSTN also has a mechanism for bilateral validation and claiming of additional duty of customs (SAD) for import of goods, creating a trail of goods imported in the GSTN.
- Bilateral validation removes the problem of:
  - Inputs claimed on fake/paper invoices, where there was no transfer of goods.
  - Duplication of claims for input tax credit by more than one entity.

Big data analytics to help trace tax evaders

- As taxpayers start filing invoice-level returns, the common GST portal can start analyzing data for tax evasion and fraud. Common formats for returns and payments, combined with electronic filing/payments and standardized PAN-based registration, will ensure data consistency.
- We believe the initial 2-3 years will be utilized to populate data, after which big data analytics will be used to trace tax evaders. Automation will lower reliance on assessing offices, reducing bureaucracy and corruption.

GSTN to plug gaps in current indirect tax



Source: GSTN, MOSL

GST will facilitate seamless flow of input credit across the entire supply chain.

Availability of input credit

- The current indirect tax regime is plagued with unavailability of seamless input credit. Taxes paid under one statute are not allowed to be set off against taxes paid under other statute. This not only leads to an increase in the prices of overall goods and services, but also incentivizes businesses to enter into unorganized trade.
- This will lead to only marginal incremental tax on value addition being charged by the value chain participant. Thus, this will ensure better compliance of the tax laws.

GST aims to achieve tax neutrality by increasing the overall tax base, passing down the benefits of lower tax rates to the consumer.

Reduction in overall tax rates

- The current multilayered taxation structure leads to taxing the tax. For example, the central government levies excise duty on the basic value of goods. However, on the sale of the goods, VAT is levied by state governments on the value of the goods including excise.
- Further, the taxes in the existing regime are higher due to a low tax base. We believe this will ensure improvement in compliance levels.

...will expand addressable market for organized players

- **Our discussions with various experts and sector participants highlight the presence of many unorganized players across sectors. We, however, believe that GST and demonetization are steps in the right direction, aiding the shift from unorganized to organized trade.**
- **This will prove beneficial for organized players as the narrowing product price differential will help them take market share from unorganized players. In our view, some organized names will benefit significantly from this shift.**

Exhibit 8: Significant market share of unorganized players across sectors

Sector	Total Market size	Organized		Unorganized		Top organized listed players
	INR b	INR b	%	INR b	%	
Home building						
Paints	406	264	65%	142	35%	Asian Paints, Berger Paints, Kensai Nerolac
Adhesive	60	42	70%	18	30%	Pidilite, Jyoti resins & adhesives
Plywood	250	88	35%	163	65%	Century plyboards, Greenply industries
Tiles	225	115	51%	110	49%	Kajaria ceramics, Somany ceramics
Luxury/ Sin Goods						
Jewellery	3,000	750	25%	2,250	75%	Titan, Tribhovandas bhimji zaveri, PC Jewellers
Alcohol	410	205	50%	205	50%	United spirits, United breweries, Radico Khaitan
Cigarettes	1,750	1,488	85%	263	15%	ITC, VST industries, Godfrey phillips
Watches	89	45	50%	45	50%	Titan
FMCG						
Biscuits	186	121	65%	65	35%	Britannia, ITC
Hair Oil	80	40	50%	40	50%	Marico, Bajaj Corp, Dabur
Beverages	524	262	50%	262	50%	Dabur, ITC, Manpasand beverages
Dairy	5,371	1,077	20%	4,295	80%	Parag milk, Prabhat Dairy, Heritage foods
Detergents	200	160	80%	40	20%	Hindustan Unilever, P&G, Jyoti laboratories
Tea And Coffee	100	50	50%	50	50%	Hindustan Unilever, Tata global beverages, Nestle
Consumers - others						
Footwear	336	134	40%	202	60%	Bata, Relaxo footwear
Garments - Innerwear	200	104	52%	96	48%	Page industries, Rupa industries
Apparel	3,550	960	27%	2,590	73%	Arvind, ABFRL
Plastic	900	540	60%	360	40%	Supreme industries, Sintex industries, Jain irrigation
Luggage	40	13	33%	27	67%	VIP industries, Safari industries
Light Electricals						
Fans	60	45	75%	15	25%	Crompton greaves consumer, Havells, Bajaj electricals
Pumps	92	64	70%	28	30%	Kirloskar brothers, KSB pumps, Crompton greaves consumer
Air Coolers	27	5	20%	22	80%	Symphony, Havells, Voltas
Domestic Switchgear	20	19	95%	1	5%	Havells, ABB, Siemens
Industrial Switchgear	38	29	75%	10	25%	Havells, Schneider electric, Siemens

Sector	Total Market size	Organized		Unorganized		Top organized listed players
	INR b	INR b	%	INR b	%	
Modular Switches	20	12	60%	8	40%	Havells
Domestic Wires And cables	80	64	80%	16	20%	Finolex cables, Havells, KEI industries
Industrial Cables	120	72	60%	48	40%	KEI industries, Finolex cables
Electrical Lighting	122	73	60%	49	40%	Crompton greaves consumer, Bajaj Electricals, Havells
Healthcare						
Diagnostic	435	65	15%	370	85%	Dr. Lal Pathlabs, Thyrocare technologies
Hospitals	4010	401	10%	3609	90%	Apollo hospitals, Fortis healthcare, Narayana Hrudayalaya
Logistics						
Logistics - Road	6,800	340	5%	6,460	95%	TCI, VRL, GATI
Auto						
Batteries	230	150	65%	80	35%	Exide, Amara Raja
Tyre	500	400	80%	100	20%	MRF, Apollo, CEAT, JK Tyre
Metals	4600	4140	90%	460	10%	Tata Steel, JSW Steel, SAIL

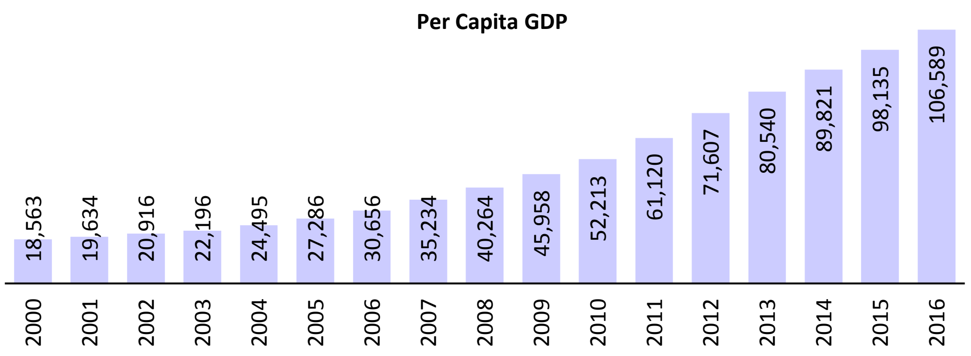
Source: MOSL

Probability/quantum of shift – critical for portfolio decision

- **Our discussions with various experts and industry participants suggest that the shift to organized trade will be instantaneous for some, gradual for others and may remain challenging for a few. For constructing a portfolio of companies that are likely to be the beneficiaries of the shift, one has to carefully consider (1) probability/timing of the shift and (b) market share expansion potential, with narrowing price differential between organized and unorganized players.**
- **The probability/timing of the shift primarily depends on the business supply chain the potential beneficiaries work with, as well as the efforts undertaken by the government to curb malpractices in the chain. The potential addressable market size expansion of players will depend on the product price differential as mentioned above, while their competitive positioning will depend on product portfolio, quality, brand appeal and distribution strength.**

- With rising per capita income in India, aspirational buying has increased over the years. This, in our view, has been gradually contributing to the shift of trade to the organized segment.

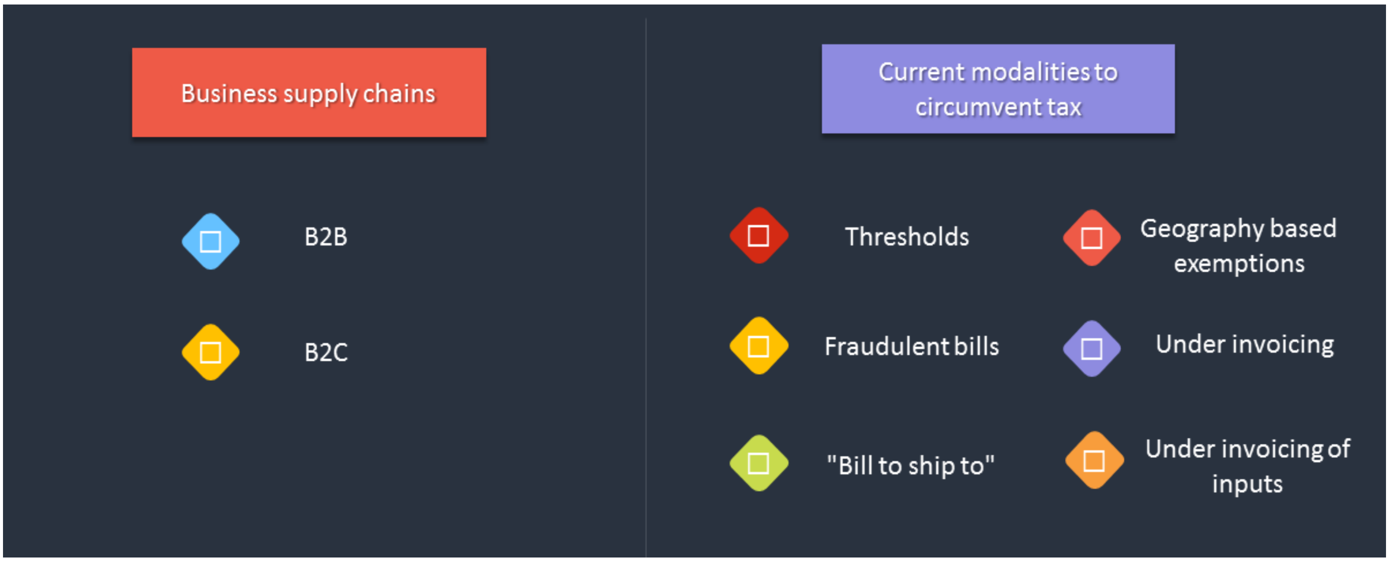
Exhibit 9: Per capita income rising over the years (INR)



Source: CSO, MOSL

- With new government initiatives, the pace of shift of trade to the organized segment might change for a few sectors. To estimate the potential acceleration in the pace of the shift for each sector, we believe one needs to clearly understand (a) the supply chain the sectors currently work with, (b) the current operational nuances of the players in the unorganized segment, and (c) how the new government initiatives will change the way the players in the unorganized segment operate.

Exhibit 10: Critical determinants of shift to organized trade

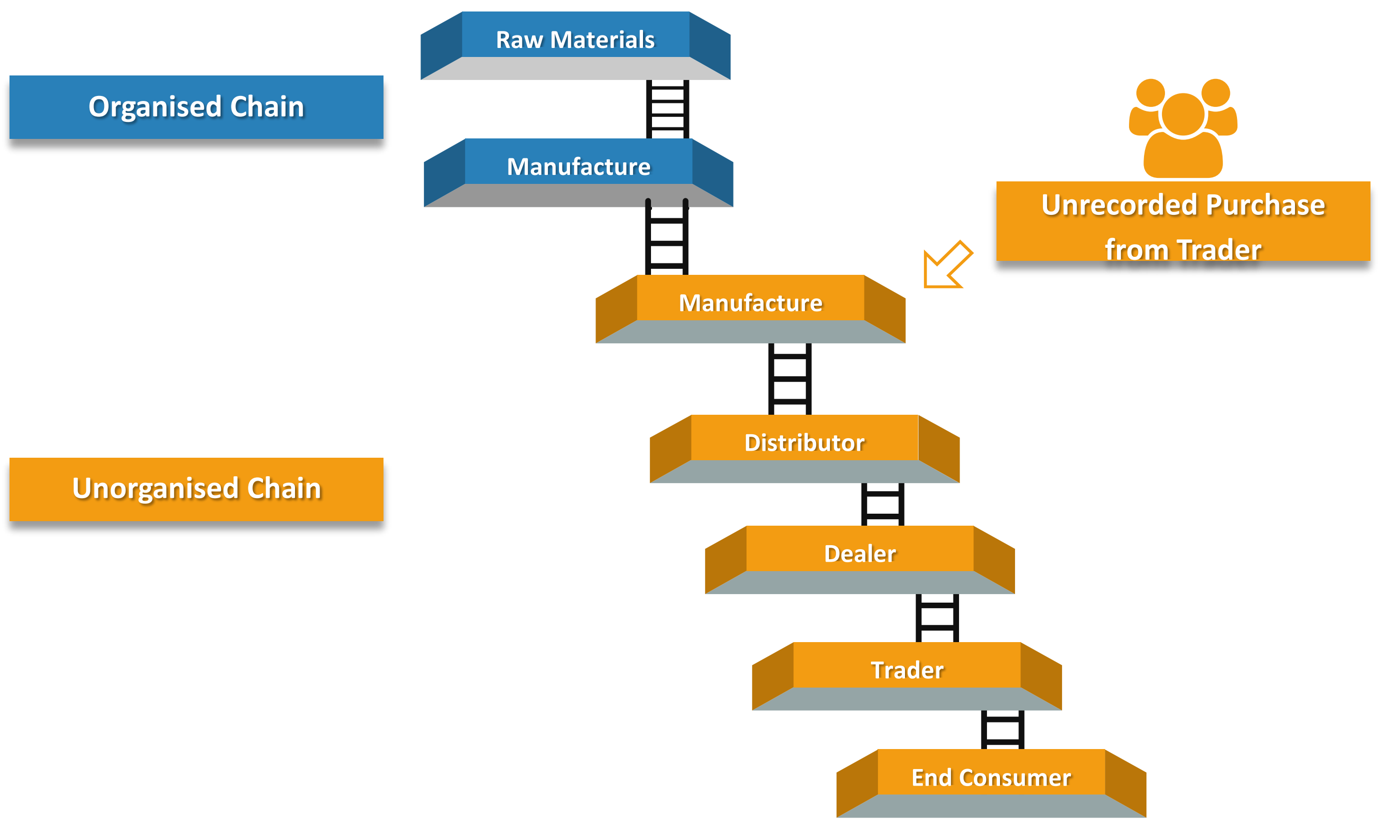


Source: MOSL

Business supply chain understanding– Critical to estimate probability of shift

- To determine the probability of shift in trade from unorganized to organized, it is imperative to understand the supply chain in which the entity operates. We note that any break in the organized chain leads to the beginning of unorganized trade. We believe that in the GST regime, a conversion to organized in the B2B chain will be relatively easy than in the B2C chain. Further, we believe that the organized chain will become more organized under the GST regime.

A break in organized chain leads to beginning of unorganized trade



Source: MOSL

Bilateral validation and availability of input credits will shift trade to organized in B2B transactions

- **Conversion in B2B chain is simpler:** Bilateral validation of invoices and seamless availability of input credit will be the key drivers of the shift to organized trade in the B2B value chain. Bilateral validation will make the identity of the purchaser known to the authorities. This, in turn, will make it difficult for the purchaser to skirt the value chain. Also, seamless availability of input credit will substantially reduce the incentive to remain outside the organized chain. We believe that B2B transactions can still remain unorganized if they either remain unorganized right from inception to the end of value chain or are done via "bill-to ship-to" mechanism.
- **Conversion in B2C chain is difficult:** Only businesses can register on the GST network and claim the benefit of input credit. End consumers will not have any direct benefits for being part of the organized chain. Furthermore, most consumers usually are indifferent to choosing between organized and unorganized players; the focus is more on pricing. Thus, we believe the shift to organized trade in short B2C chains (where manufactures/service providers source raw materials/inputs from the unorganized market, and continue supplying in unorganized manner throughout the supply chain) will be difficult.
- **Organized chains will become more organized:** Usually, the business supply chain (wherein goods are manufactured by large organized companies) remains organized till the distributor or wholesale level. The last few legs of the chain (i.e. from semi wholesaler to retailer or from retailer to customer) remain outside the tax net as these entities do not record the purchase/sales transactions (done mostly in cash) in their books. Under GST, due to bilateral validation, the identity of the purchaser will become known in the system. This will ensure that even the last legs of the chain are organized.

Understanding of modality of operation and measures adopted to curb malpractices

To understand the probability/timing for the conversion to organized trade, we need to understand the current loopholes in the system and whether the changes in regulations/administering mechanism will be able to address those. Various modalities are prevalent currently and the likelihood of their conversion are discussed below:

- **Entities taking benefit from higher exemption threshold to be impacted in near term:** With the reduced threshold under GST, it will become difficult for entities to remain outside the organized chain. We believe that such entities will shift to organized segment in the near term, unless they are able to manage from procuring inputs to selling goods via unorganized trade without being traced. Currently a lot of entities in home building (plywood, tiles etc), consumers (biscuits, apparel, plastics) etc operate using such method.
- **Geography-based exemption to no longer exist:** GST will lead to the end of the era of geography-based exemptions. Hence, businesses that are currently managing to keep them themselves in the unorganized supply chain by taking advantage of geography-based exemption are likely to convert to organized trade over the near term.

  Product base exemption may continue albeit at a lower scale: Currently, various state governments exempts ~400 goods from the levy of indirect taxes under their jurisdiction. These goods are generally primary inputs for manufacture of taxable goods. The difference in the tax rates of input and output goods incentivizes the entities to remain unorganized. Government intends to scale down the product based exemptions from ~400 currently to ~100 under GST. We believe that while scaling down of number of exemptions will lead to a significant containment in the unorganized sector. Some of the sectors in which such mechanism is currently prevails are consumers, apparels etc.

- **Unrecorded purchases/sales will be impacted in near term:** Bilateral validation will make the identity of the buyer known to the tax authorities. Hence, it will be imperative for all entities to record purchases and corresponding sales for legitimate invoices. Further, seamless availability of input credit (especially in inter-state transactions) will be an added incentive for businesses to keep a record of the transactions. However end to end unorganized chain can continue to exist.

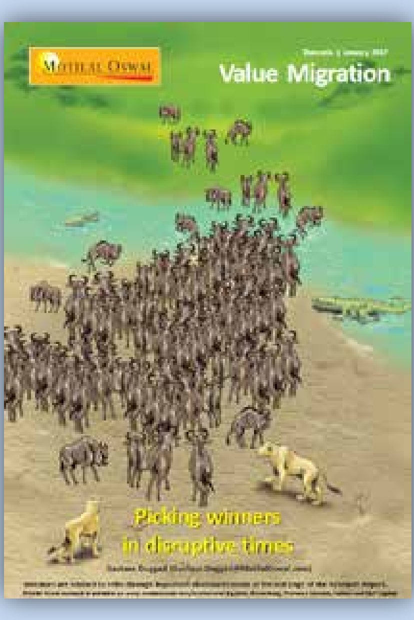
"Bill to ship to", under invoicing of inputs, end to end unorganized chain can still sustain post GST

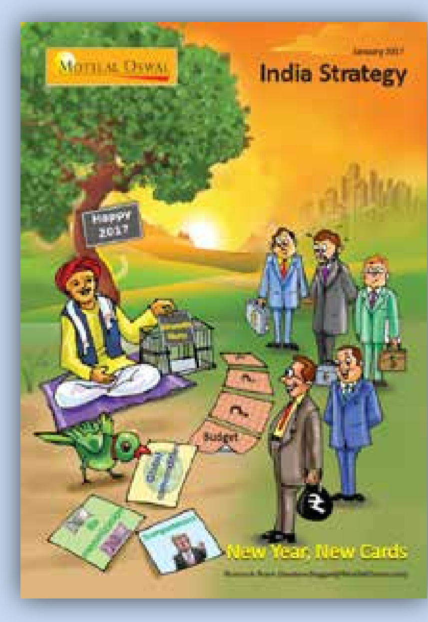
- **"Bill-to ship-to" can continue:** In some instances, two or more companies collaborate with each other, wherein one takes the physical delivery of goods, while the other just accounts for purchase of goods in its financial books for mutual benefit. Companies recording the transactions in their books claim the input tax credits and also gain by claiming additional expenditure to underplay taxable profits in their income tax filings. On the other hand, companies getting the physical delivery of goods use it for unorganized manufacturing/distribution. Such practices can continue even under the GST regime if businesses are able to skirt the input-output norms – this is the ratio (based on industry standard) of calculating output based on the inputs purchased. We believe that input-output norms are difficult to implement practically. Further, it can be put to use only after 3-4 years of collecting adequate data of the industry. Such practices are prevalent in detergent manufacturing and other sectors.
- **Under-invoicing in imports may remain:** Some entities import goods at an invoice value that is lower than the fair value**.** This helps them to minimize the incidence of levy of indirect taxes on such imports. Further, the goods are sold in the unorganized markets in cash, while the invoices against imports are made separately based on the under-invoiced price. We believe that GST in its current form may not be able to address this. Hence, this practice can continue for longer. However, participants will need to under-invoice the product in the entire value chain post its import. Significant imports happen currently in sectors like light electrical, tyres etc.

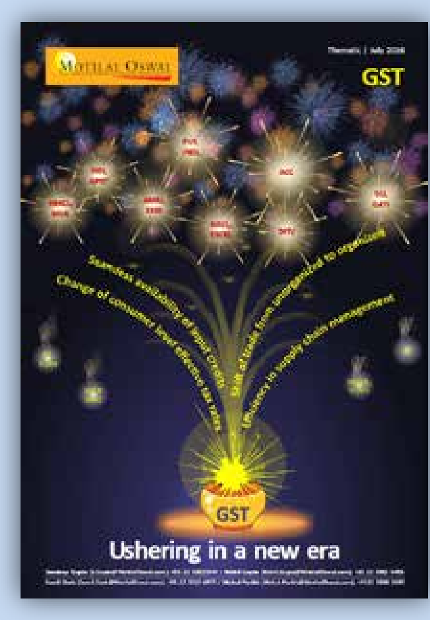
Our forthcoming research on the subject

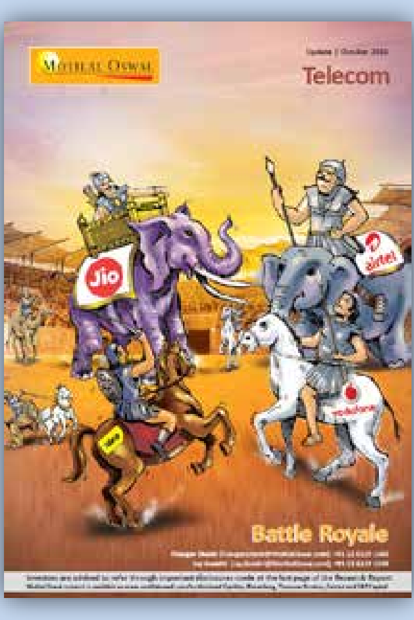
- In our forthcoming note on this subject, we will focus on sector-level implications from the shift to organized trade.
- More specifically, we will discuss about how (a) the unorganized players currently manage their supply chain, (b) what ways they adopt to circumvent taxes, (c) whether they will continue being part of the unorganized chain or shift to organized trade, and (d) if they will be able to deal with the potential reduction in the price gap due to removal of tax arbitrage.

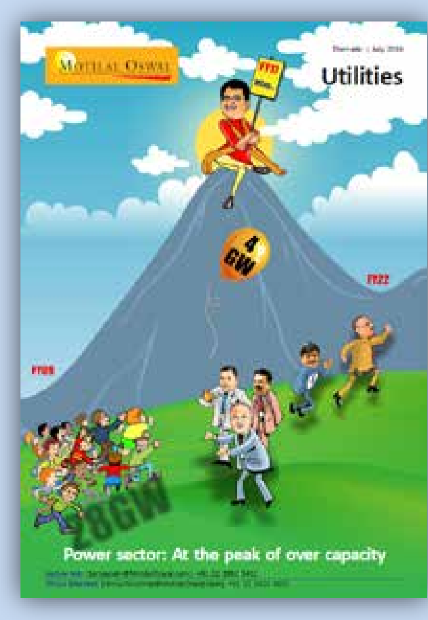
THEMATIC/STRATEGY RESEARCH GALLERY











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