

Effect of VAT and Service Tax Changes on Apparel Manufacturing and Retailing

For the past two years, India's apparel industry is going through a period of turbulence, unexpected changes and challenges. In 2011, the industry struggled due to the unexpected fluctuation on fiber prices, and especially the price of cotton. The introduction of 10% excise duty on branded apparel in the Union Budget for 2011-12 added to the problems faced by apparel manufacturers and retailers. The Union Budget for 2012-13 provided minor relief in terms of excise duty, but service tax rate was increased from 10.3% to 12.36%. At the same time, many of the state governments implemented VAT on apparel. The weak economic outlook, reduced consumer spending, and rising costs, coupled with the newly introduced excise duty on branded apparel, increase in service tax, and implementation of VAT remained the moot points of the industry for the year 2012.

Excise Duty on Branded Apparel

The industry's tax-related challenges started in 2011-12 with the introduction of 10% excise duty on branded apparel with an abatement rate of 55%. In 2012-13, the abatement rate was increased to 70%, but the excise duty increased from 10% to 12%. As a consequence, the effective excise duty decreased from 4.5% to 3.6%, a reduction of 90 basis points. **VAT on T&A: A Contentious Issue**

For a manufacturer and retailer, value-added tax, or VAT, is applicable to the 'value addition' part of the product. However, from the consumer's perspective, the tax is an additional burden, as she/he has to pay a higher amount for the same apparel. Apparel retailers are forced to think about the impact of any kind of purchase price increase on consumer spending. And in order to prevent the tightening of purses by consumers, retailers and manufacturers, they often need to shrink their own profit margin so that the effect of price rise will not get transferred to the end consumer.

The implementation of VAT for the apparel industry has been a contentious issue for a long time. VAT being a concern of state governments rather than the Union government, there are differences in the tax rates imposed. Governments in Delhi, Uttar Pradesh, Punjab, and Rajasthan charge a VAT of 5% on apparel while most other states charge 4%. On textile items, some states are charging VAT, while some other states were forced to rollback VAT after an initial announcement. Nonetheless, the imposition of VAT has added to the complexities of the country's textile and apparel value chain that extends across more than one state, and has negatively affected both consumers and manufacturers of readymade apparel.

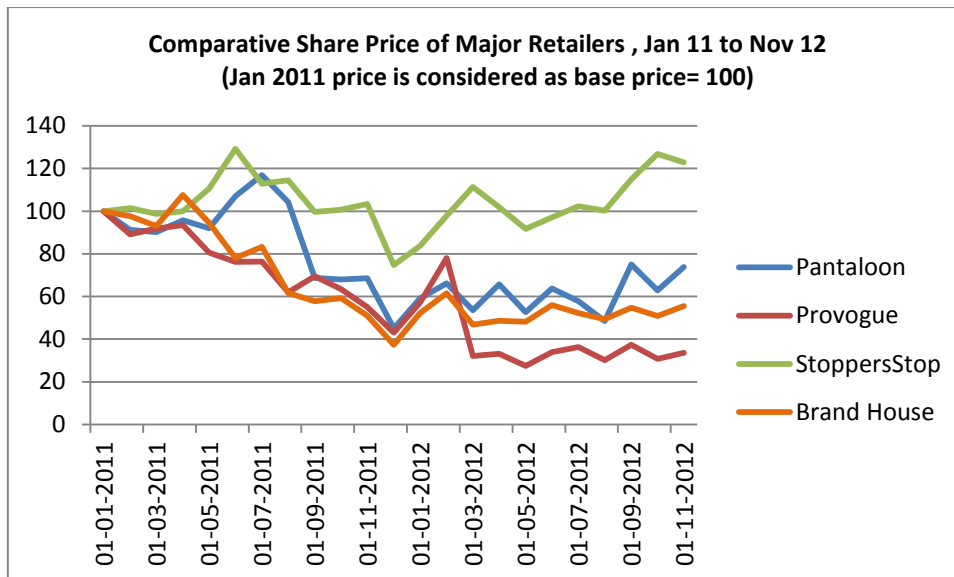
2% Increase in Service Tax

In fiscal 2012-13, the service tax was increased by 2% and additional service categories, which were previously exempted from tax, were included in the list. As a result, retailers and manufacturers witnessed an increase in their costs, as they had to pay an additional tax for each service they had used, e.g. rent, electricity, etc. Most of the retailers had to compromise on their profit margin so as to protect the customer from the heat of the tax.

Overall Impact of Taxes

Due to the combined effect of taxes, the average sales price of apparel products increased by 5-6%. The prices of branded apparel had already increased by 10-12% in the previous year on account of the high raw material price and the introduction of excise duty. Most apparel retailers had witnessed a negative growth of 4-5% in their volume sales for the first half of the fiscal year 2012-13. But they managed to maintain their revenues due to the increase in average sales price. The EBITDA margins of some retailers plummeted as transferring all the cost to consumer was not possible. Most of the retailers attributed the drop in EBITDA margin to the hike in service tax and also power cost, which increased by 25-30% per unit.

Additionally, the share price of most retailers dipped in 2011 and 2012 due to declining volume growth and increasing price. Policy reforms on FDI in multi-brand retail helped some apparel retailers to perform better in the share market in the latter part of 2012.



Source: BSE, share prices adjusted for dividends and share splits

GST: The Solution Awaited

Many apparel retailers are looking forward to the implementation of the Goods and Services Tax (GST). The strength and commitment with which the Indian government has started introducing policy reforms provides a lot of hope for the timely implementation of the GST in India, which is expected to come into effect by fiscal 2013-14. Under the present tax regime, taxes on services cannot be set off against taxes on goods. Retailing being a service industry has to pay service tax, despite the tax paid on goods manufacturing. GST is expected to not only solve the problem of service tax, but also reduce the other tax related complexity in value chain through the introduction of uniform SGST (State GST). It might in fact impact the apparel industry in a positive way as it will reduce tax payments in services, real estate rents and other service-related activities. The benefits will percolate upstream to the apparel manufacturer as well.

Key Takeaway for the Industry

Despite the challenges of taxation, apparel manufacturers and retailers must see these difficult times as an opportunity for learning and improvement. The increase in taxes is a reality that the industry cannot escape and companies need to look internally for other means of reducing costs. Manufacturers need to focus on improving operational efficiencies in order to offset increased tax rates etc. Companies need to be better prepared to compete in the marketplace through various measures including a focus on quality parameters, more efficient supply chains, better understanding of consumer requirements, etc.

While taxes are necessary for the growth of the economy, it is also important to have a consistency in policy structure. The industry is more affected by constant changes and uncertainty in tax policy. Therefore, governments need to work toward a more uniform and consistent taxation policy.

The textile industry will definitely benefit from the timely implementation of GST and any other favorable policy initiatives. However, in the long run, apparel manufacturers and retailers, geared internally with efficient systems and streamlined processes, are likely to compete better in the face of external challenges.

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