GST is high on the agenda for the new government and its rollout is a priority. The cascading effect of local taxes and complexity of the current regulatory structure of central and state bodies are adding to the inefficiencies of the Indian pharmaceutical sector already under margin pressure from rising costs and increasing span of drugs under price control. GST will benefit the Indian pharmaceutical manufacturers by rationalizing the tax structure and optimizing distribution. Even a 2% reduction in production or distribution cost will add to the profits by over 20%. It could be the single biggest shot in the arm for the Pharmaceutical industry and create competitive advantage for those who move early, say Manish Panchal (Practice Head – Chemicals, Lifescience & Supply Chain) and Siddharth Paradkar (Principal – Logistics & Supply Chain) of Tata Strategic Management Group.
Introduction

The Indian Pharmaceutical industry with a domestic turnover of over USD 15 billion is amongst the largest producers of pharmaceutical products in the world (by volume). While the sector has been witnessing high growth over the past decade it has been burdened with diminishing margins. The domestic industry is facing pressures of increasing span of price control on account of changing regulations, price erosion with more generics and increasing competition added by lack of R&D productivity and limited new molecules. Multistage taxation in the pharmaceuticals industry i.e. Customs duty on imports, Central excise duty on manufacture, Central Sales Tax (CST) / Value Added Tax (VAT) on sale of goods, Service tax on provision of services and levies such as entry tax, octroi, cess by the State or municipalities; loss of credit of tax paid, adds to the inefficiencies and cost. GST will help in rationalizing the tax structure and could be the single biggest shot in the arm for the Pharmaceutical sector.

What is Goods and Services Tax (GST)?

GST is an evolution of the current tax regime, transforming the complex and cascading structure into a unified value added system of taxation. Under this, a value added tax would be levied at every point of the supply chain providing for credit for any / all taxes paid previously.

Keeping in line with the governance structure of the country GST would be levied simultaneously by the Centre and State (CGST and SGST respectively). All essential characteristics in terms of its structure, design applicability, etc. would be common between CGST and SGST, across all states.

GST is expected to replace most of the current applicable indirect taxes as listed in Exhibit 1.

Benefits to the Pharmaceutical Industry

Implementation of GST will have significant impact and will change the manner in which business is carried out in comparison with the existing ways.

The application of a single tax rate across all goods and service will result in redistribution of taxes across all categories. This will lead to a reduction in taxes on manufactured goods and thereby impacting the pricing of the final product.

The integration of tax on Goods and Services through GST would provide the additional benefit of providing credit for service tax paid by manufacturers. Both CENVAT & VAT, which are being levied at present, give tax credit to the manufacturer for the tax paid for raw materials (hence a tax is charged only on the value added by the manufacturer). More often than not, there are various services including logistics involved in getting the input material to its final customers. Service tax is paid on the cost of such services too. With the implementation of GST, cost of any service, including logistics, will be considered as value add, and the manufacturer will get tax credit for the service tax paid.

The biggest advantage to the industry would be that of reduction in transaction cost, with an immediate impact coming from the discontinuance of CST. The multistage taxation along with the inability to take full benefit of the CENVAT credit / refund has been an issue for the industry. With central GST expected to be a single rate for goods and services, going forward credit accumulation may not be an area of concern. Furthermore, if the legislation provides for carrying forward of the unutilised credit this would be an additional boost to the industry.

India a single common market

Under GST inter-state sales transactions between two dealers would be cost equivalent and comparable with stock transfers / branch transfers. Inter-state transactions would become tax neutral, making India one single common market no longer divided by state borders (Exhibit 2). This will result in lower cost which can add to margins or can be passed on to customers.
Opportunity to explore alternate distribution models

Organizations will be able to explore different distribution models such as setting up mother warehouses and regional distribution hubs and consider stepping away from traditional C&F and distributor based models currently adopted. This will lead to logistics and distribution to evolve as a competitive advantage through improved service levels, faster turnaround times and better fill rates at lower costs.

Rationalization of Warehouses and Transport network

GST would do away with the existing penalties on inter-state sales transactions and facilitate consolidation of vendors and suppliers, eliminating the need to have state wise warehouses to avoid CST and the associated paperwork. This will enable companies to consolidate warehouses, rationalize their networks and take advantage of economies of scale, improved efficiencies, better control and reduction in inventory (i.e. working capital deployed in the business). For example: By setting up a large warehouse in a place like Zirakpur, a large logistics hub with good infrastructure, a company can serve markets across the states of J&K, Himachal, Punjab, Uttarakhand and Haryana as against having five different warehouses to serve these markets in the current scenario.

Furthermore, the pharmaceutical sector currently enjoys various location based tax holidays on its manufacturing activities. Under the proposed structure of GST, such area based exemption will be done away with. However, taking into account past precedents suitable work around/refund process would be constituted to ensure that any existing hubs do not get impacted and continue to get the agreed benefits. However, the challenges faced in distributing from these remote locations could be addressed by designing logistics efficient networks of mother and daughter warehouses to ensure optimization of cost and superior availability of products.

While the qualitative benefits arising out of GST are well established, there is a definite impact to economics of companies as well. Logistics cost accounts for nearly 13-14% of our GDP. Of the total logistics cost transportation contributes ~35%, warehousing & storage ~10%, inventory holding cost ~25% and other inefficiencies’ make up the balance 30%. Implementation of GST and alignment of a firm’s supply chain to it will directly help in reducing cost on transportation, warehousing and inventory holding by 5-8%, 10-12% and upto 28% respectively for each of the cost heads, leading to an overall savings in the range of 10-12% of the total logistics cost.

Looking Forward

The government has already begun the process of getting the necessary consensus from all the stakeholders to pave the way for implementing this landmark tax reform. Though the exact details are still sketchy, the structure and deliverables have been clearly laid down for all to see. The government has set itself an ambitious target to roll it out by July 2015.

As Indian pharmaceuticals companies look forward to revenue growth on one side and the need to reduce costs, GST offers a great opportunity to revisit their Supply Chain & distribution strategy to develop an agile, customised and cost-efficient supply chain. Companies need to act now to assess the impact of GST on their businesses and functions and develop an action plan and road map for the future. Those who move early are likely to gain an advantage on cost and service levels over their competitors and deliver a better value proposition to the customer.

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- Increasing presence outside the Tata Group & India
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✓ Chemicals
✓ Energy

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✓ Scenarios & Risks
✓ Sustainability

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- Market insights
- Entry / Growth Strategy
- CSR Strategy

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- India Entry
- Alliance & Acquisition Planning
- Strategic due diligence
- Manufacturing Strategy

- Organization Structure
- Culture & HR Transformation
- Manpower Planning & Optimization
- Leadership Development & succession planning

- Marketing & Sales
- Revenue Enhancement
- Product Innovation
- Channel Effectiveness
- Route to Market

Implementation Support

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- Throughput enhancement
- Superior Fulfillment
- Project Excellence
- Procurement Transformation
- Resource Management

- Program Management
- Change Management
- Benefit Realization

Logistics

The Logistics Practice at Tata Strategic has in-depth understanding of Indian Logistics Sector having have experience in conducting several in-depth market studies and growth strategies for clients in the logistics space. We have also assisted large corporates and MNCs in setting up their distribution network, overhauling their existing distribution networks, logistics cost optimization and inventory optimization.

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