WORLD GOLD COUNCIL

Market Update
GST's impact on India's gold market

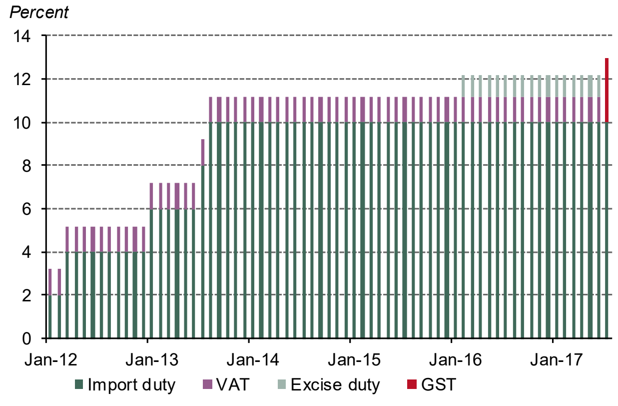
June 2017 www.gold.org

On 1st July, India's labyrinth of taxes will be replaced with a simple, nationwide Goods & Services Tax (GST). This is the biggest fiscal reform since India's liberalisation in the early 1990s. While gold consumers will face a slightly higher tax rate, and the industry will go through a period of adjustment, we see the net impact on the gold industry as being positive. The gold supply chain should become more transparent and efficient, and the tax reform could boost economic growth, which we see as supporting gold demand.

Gold GST– lower than feared

The tax on gold is set to increase from 1st July 2017. Prior to GST being implemented, the overall tax rate on gold jewellery stands at 12.2%. This is made up of 10% customs duty, 1% excise duty, and 1.2% VAT.[1] GST replaces the excise duty and VAT components, but sits on top of the import duty. The headline gold rate of 3% announced on 3rd June has been welcomed by the industry, as it is significantly lower than many had feared. And, on the face of it, represents only a modest tax increase. **(Chart 1)**

Chart 1: The tax on gold has steadily increased



Source: Central Board of Excise and Customs; GST Council

[1] VAT varies state-by-state from 1% in Rajasthan to 5% in Kerala. Additional local taxes can push the overall tax on gold jewellery even higher

But when we delve a little deeper, the effect of the tax is a little more complex. There are two important GST rates which will affect the industry. The first is the 3% tax on gold products, such as jewellery. In addition, there is an 18% tax on services that will apply to firms and individuals providing manufacturing services across the gold supply chain. This is a significant part of the industry.

Taking these two rates into account, our analysis of the supply chain indicates the effective tax rate consumers face could increase to between 13.5 -14%. This range depends on whether the jewellery is manufactured in-house or is outsourced. Firms manufacturing jewellery in-house will have an advantage.

This, however, overlooks the broader tax efficiencies GST will bring. A key benefit of the new regime is that a firm can offset the tax it pays against its revenues using *input tax credits* (please see the Focus Box: What exactly is GST?), and double taxation throughout the supply chain should be eliminated. Jewellers, for example, will now be able to use input tax credits from any goods and services used in the process of selling jewellery.

Any tax efficiencies gained in the supply chain will be passed on to the consumer. One might be concerned firms could use input tax credits to fatten their margins. But anti-profiteering legislation will ensure this is policed, and that firms pass on the benefits to the end consumer.

The devil is in the detail when it comes to tax. While the GST rates have been announced, there are several areas where greater clarity is required. But there are still some key themes worth highlighting.

Consumer impact

We see consumer behaviour changing in response to GST. Our econometric analysis spanning 26 years of data illustrates that higher taxes act as a headwind to gold demand.[2] But the tax should also change the industry to the benefit of the consumer.

Consumers currently get a bad deal. The industry is highly fragmented, dominated by small independent retailers where under-carating is rife. While most analysts think of India's jewellery market as being dominated by 22k, the reality is that most of the jewellery sold has less gold in it than advertised. GST will bring greater transparency to the supply chain, and bring more of the gold market into the formal sector. We expect this to make it harder for retailers to under-carat their customers.

[2] Please see the appendix in India's gold market: evolution and innovation

And separately, a slew of measures from the Bureau of Indian Standards is pushing the industry towards mandatory hallmarking, which will also tackle the issue of under-carating.

The direction of travel seems clear to us: India's gold market is becoming more organised and transparent, and it is likely GST will accelerate this process. This should be good for consumers. They can have more faith in the gold products they are buying, and this in turn can support gold demand in the years to come.

Recycling at risk

GST could also affect India's large gold recycling market. Selling gold to a jeweller is now a taxable transaction, for which the jeweller is liable. The jeweller pays the tax which is offset by the input tax credit they receive. This will make this part of the market more transparent.

But this transparency may come at a cost. The tax authorities will know who has sold gold and how much they have sold.

It will be interesting to see how consumers and retailers respond. This part of the market might clam up. Or some consumers and jewellers may try to conduct the transaction under-the-counter so it does not get captured by GST.

A more efficient supply chain

Firms across all product categories are re-jigging their supply chains in response to GST. Overall, supply chains are likely to become more efficient. This is true of the gold industry. Under the current tax regime, for example, inter-state sales of jewellery attract an irrecoverable central government sales tax. To avoid this, firms have set-up warehouses in states where they conduct business so sales are booked intra-state, rather than inter-state. This is inefficient. Businesses often have multiple warehouses across India, with high logistical costs and they often hold excess levels of inventory.

Under GST, while inter-state stock transfers will be taxable, the tax can be reclaimed once the goods are sold. If, for example, a large nationwide retailer had excess jewellery stock in one state and wanted to transfer it to a store in another state, it would pay IGST, which it can then off-set against sales revenue. Being able to reclaim the tax removes the incentive to maintain stock in multiple warehouses across India, and will allow retailers to become more efficient by consolidating warehouses and holding lower levels of inventory.

While there are efficiency gains to be made by the gold industry, there are some issues which may pose challenges.

In some instances, firms may have valuable working capital tied up. As explained above, under GST the inter-state stock transfer will be taxable. In this example, working capital may be tied up from the time at which the stock transfer is made (and GST is paid) to when stock is sold by the receiving store and the tax is reclaimed.

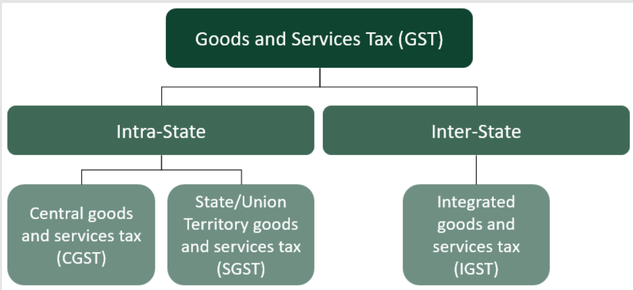
Artisans – individuals or small collectives who hand-work intricate pieces of jewellery for larger manufacturers – fall outside the current tax rules. Under the new rules, however, artisans with a turnover north of Rs2m per annum will need to become GST-registered. On top of this, jewellery made by artisans subcontracting for larger manufacturers from another state would be treated as inter-state supply and subject to IGST, even if the artisans do not reach the turnover threshold of Rs2m per annum. This may not be feasible for small-scale craftsmen.

Focus box: What exactly is GST?

GST is a destination-based tax on the supply of goods and services. This means that each party throughout the supply chain – as long as their turnover is greater than Rs2m per annum - will be liable for GST when they buy a good or service. Once they have paid GST, providing they are buying the product from a GST-registered firm, they will receive an *input tax credit* to offset the tax against revenues from the sales of goods and services.

While one GST rate will be applied to each good or service across India, there are three different elements of the tax:

1. Central goods and services tax (CGST). This is the element of the GST which flows into central government's coffers
2. State/Union Territory goods and services tax. This is known as SGST for 29 states and two Union Territories with legislatures, and UTGST for Union Territories without legislature. This is the element of GST which is retained by the State or Union Territory
3. Integrated goods and services tax (IGST). This is levied on all imports into India and inter-state flows of goods and services. It has been drafted as separate legislation so the central government can monitor international trade flows and the movement of goods between states



At first glance the different terminology suggests there are different types of taxes being levied. That is not the case - GST is the only tax levied. The terms explained above exist to direct the flow of tax revenues to central government or the state and to allow authorities to track imports and intra-state trade.

The GST Council - the government body which sets GST rates on goods and services, drafts GST laws, and makes recommendations on goods and services that are exempt from GST - has settled so far on an eight-tier structure with rates of 0%, 0.25%, 3%, 5%, 12%, 18%, 28% and a more punitive rate of at least 43% to be levied on *luxury* and *sin* goods, namely tobacco, cigarettes, fizzy drinks, coal, and motor vehicles.

Industry consolidation

India's gold market is highly fragmented. Jewellery's retailing landscape is dominated by small businesses – regional and national chains only account for around 30% of the market. The picture in jewellery manufacturing is more extreme, with 95% of the industry consisting of small-scale operations.

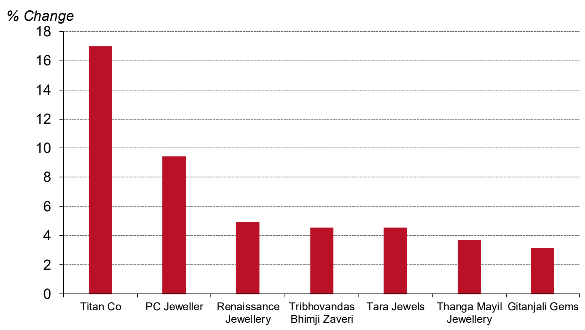
But this is changing. In recent years, large retailers and manufacturers have been gaining market share. It is likely GST will accelerate the pace of consolidation. Firms that currently outsource manufacturing services from artisans and incur the 18% GST rate may look to develop in-house capabilities. Small jewellery shops which may have illegally benefited by not paying tax will lose that advantage, and large retailers can compete on a level playing field. In its Q1 report to the market, Titan noted that *"… we believe that the formalization of the economy bodes well for our jewellery division, Tanishq"*. [3]

Positive market reaction

Industry has reacted positively to the 3% GST rate. There had been fears it could have been higher – perhaps 5% or more. This would have had a damaging effect on consumer demand and, more importantly, would have meant many small, independent retailers would have done their best to avoid it. The 3% rate is viewed as being more manageable and will ensure greater compliance by small and independent retailers. Commenting on GST, the All India Gems and Jewellery Trade Federation (GJF) Chairman, Nitin Khandelwal said, *"…we welcome the government's decision of 3% GST for gold. We are happy that the Centre has created a special category, which will help the industry."*

Large organised retailers should be especially pleased. It will make their operations more tax efficient and put them in a stronger position to gain market share. On the first day of stock market trading after the GST announcement, listed jewellers outperformed the broader equity market by an average of around 6%. **(Chart 2)**

Chart 2: Listed Indian jewellers outperform



International gold flows

Gold exports may receive a boost. GST has been designed so it continues to support special economic zones (SEZs). Firms operating within SEZs are entitled to bring goods from the domestic tariff area (DTA) or from abroad without paying IGST. This will ensure working capital is not tied up for firms based in SEZs. A fast and efficient tax refund process – the government promises to rebate 90% of claims from firms in the DTA within 6-10 days – coupled with tax exemptions for SEZs, could encourage exports and enhance Prime Minister Narendra Modi's *Make in India* initiative.

In recent years, there has been a strong tax incentive to import doré rather than bullion. Refiners in the excise free zones (EFZ) found it especially profitable to do so.[4] Doré imports and refining capacity boomed.

This incentive may increase further. GST will replace both the excise and countervailing duty, further increasing the tax differential between doré and bullion imports, but levelling the playing field between refiners in EFZs and the DTA. Doré imports could boom and bullion imports could collapse. This would be very positive for refiners across India. The big question is whether the authorities will announce further tax legislation to remove this incentive.

GST: boosting the economy

India currently has a complex tax system. Each of India's 29 states set their own sales tax rates. These taxes are often on top of central government taxes. Double taxation is rife, pushing up prices for consumers. And states usually treat goods coming in from neighbouring states as imports and goods leaving its boundaries as exports, and tax them accordingly. These taxes create barriers to the movement of goods, services and capital around the Union. Frictions like these hinder intra-India trade, are a barrier to economic growth and encourage shady practices in GST is designed to smash through this barrier to prosperity. From July 2017, one single rate will apply to each product nationwide, replacing more than a dozen different types of central government and state taxes. There is a widely-held consensus that this will boost economic growth. A government committee chaired by Arvind Subramanian, Chief Economic Advisor to the Government, estimated GST will boost economic growth by 0.5%.[5] The National Council of Applied Economic Research (NCAER) is punchier, estimating gross domestic product could

[3] Quarterly Update: Q4 FY 16-17

[4] For information please see page 62 in India's gold market: evolution and innovation

[5] Report on the revenue neutral rate and structure of rates for the Goods and Services Tax, 2015

rise by 0.9-1.4%.[6] This is on top of already impressive economic growth: the World Bank expects India to grow at 7.2% in 2017, before accelerating to 7.7% in 2019.[7]

GST will also widen the tax net and swell state and central government's coffers. According to ICICI Securities, GST should boost central government and state revenues by Rs3.9tn. [8] This is partly because the structure of GST – as outlined in the focus box - will make tax administration easier and improve tax compliance. Tax evasion will become a lot harder under GST.

This should support gold demand. In our recent report, India's gold market: evolution and innovation we conducted detailed econometric analysis which highlights that income growth is the single most important factor driving gold demand.[9]

Outlook

We believe GST may be disruptive in the short term as the industry adjusts to the new tax regime. Manufacturers' and retailers' working capital could be tied up because of inter-state gold stock transfers. Small-scale artisans and retailers with varying degrees of tax compliance may struggle to adapt. Consumer demand faces a headwind from the higher rate of tax. And consumers and jewellers may try to conduct recycling transactions under the counter, away from the prying eye of the tax man.

But the positives are significant. GST should eliminate double taxation and improve supply chains efficiency. GST can make the gold industry more transparent which, coupled with recent hallmarking legislation, should ensure gold buyers have confidence in the gold products they buy, rather than continuing to suffer from the gross level of under-carating they have previously endured.

And India's entire economy is on a rapid journey to becoming more organised and more transparent, boosting economic growth. This is vitally important for India's gold market: our econometric analysis reveals that income growth is the single biggest driver of gold demand in India.

In summary, GST represents a radical step forward for India's economy. While it could present short-term challenges to the gold industry, we believe it will boost the economy and make the gold industry more transparent to the benefit of gold buyers. This should support India's gold demand, which we expect to be between 650-750t in 2017, rising to 850-950t by 2020.

[6] India makes progress on GST implementation, 2014

[7] Global Economic Prospects 2017, World Bank

[8] Market Wrap, ICICI Securities, 2015

[9] Please see the appendix in India's gold market: evolution and innovation

About the World Gold Council

The World Gold Council is the market development organisation for the gold industry. Our purpose is to stimulate and sustain demand for gold, provide industry leadership, and be the global authority on the gold market.

We develop gold-backed solutions, services and products, based on authoritative market insight and we work with a range of partners to put our ideas into action. As a result, we create structural shifts in demand for gold across key market sectors. We provide insights into the international gold markets, helping people to understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society.

Based in the UK, with operations in India, the Far East and the US, the World Gold Council is an association whose members comprise the world's leading gold mining companies.

World Gold Council
10 Old Bailey, London EC4M 7NG
United Kingdom

T +44 20 7826 4700
F +44 20 7826 4799
W www.gold.org

For more information

Please contact

Mukesh Kumar
Manager, Market Intelligence
Mukesh.Kumar@gold.org
+91 22 6157 9131

Louise Street
Manager, Market Intelligence
Louise.Street@gold.org
+44 20 7826 4765

Krishan Gopaul
Manager, Market Intelligence
Krishan.Gopaul@gold.org
+44 20 7826 4704

Alistair Hewitt
Director, Market Intelligence
Alistair.Hewitt@gold.org
+44 20 7826 4741