



FEBRUARY 2017 – INDIA: REGULATORY UNCERTAINTY LIKELY TO PERSIST; TAX REFORM TO REDUCE SUPPLY CHAIN RISKS

Driven by rising income levels and comparatively low car penetration rates, India continues to be one of the world's fastest-growing automotive markets. Currently valued at USD 74bn, government estimates from 2016 expect the sector to achieve an annual turnover of up to USD 280bn by 2026 – an impressive compound annual growth rate of 14.2%. While this projection may be somewhat optimistic given the market contractions between 2011 and 2014, there is no doubt that globally-oriented automotive firms cannot afford to ignore the Indian market.

Like in many other jurisdictions covered in this series, India's evolving regulatory framework poses challenges as well as opportunities. A prime example is the Goods and Services Tax (GST), a proposed tax reform that we expect to significantly shape the long-term growth prospects of the sector by creating, for the first time, a single market in India.

Sudden and dramatic regulatory changes

As the Indian automotive sector matures, investors are likely to continue experiencing dramatic regulatory and policy changes. A recent example is last year's ban on the sale and registration of diesel vehicles with an engine capacity above 2000cc in the greater Delhi region, one of the country's biggest auto markets. Pronounced in December 2015 by the National Green Tribunal, a quasi-judicial body, India's Supreme Court overturned the ban in August 2016, implementing instead an "environment compensation charge" amounting to 1% of a vehicle's retail price.

Industry representatives estimate that the temporary ban cost manufacturers USD 590m. Investments were put on hold and manufacturers of luxury cars scaled down production of diesel vehicles. The issue is far from resolved: the federal government opposes the environmental compensation charge, the Supreme Court is considering environmental fees on all diesel vehicles, and the National Green Tribunal maintains that the ban was only lifted for personal, not commercial, vehicles.

The Delhi diesel ban highlights a common challenge of regulatory change in India: the complex relationship between different decision-making bodies. Time and again, we have found in our work that understanding the motivation of different regulatory actors is as important as is grasping the policies themselves.

Tax reform and reduced supply-chain risks

We expect July 2017 to finally see the implementation of the Good and Services Tax (GST), a proposed reform of India's complex web of indirect taxes. The GST has been in the making since 2007 and, according to a recent statement by Finance Minister Arun Jaitley, will be rolled-out over a six-month period starting in July.

India's current system of indirect taxation is highly convoluted, with a plethora of taxes being levied by individual states, as well as by the federal government. While teething troubles are likely, we anticipate businesses to benefit

considerably from the introduction of a uniform tax system and a reduction of bureaucratic red tape. Supply chain-heavy sectors like the automotive industry, in particular, are expected to benefit from streamlined compliance requirements and more efficient logistical operations.

One example for this process is the proposed system for digitised tax payments, which will increase transparency and reduce taxation-related corruption risks. The reform is also likely to marginally reduce indirect taxes by manufacturers, improving productivity. Finally, with around 80% of vehicle sales made outside the state of manufacture, the GST is expected to give a boost to the domestic automotive market by removing the effects of cascading taxes on consumers. Overall, we foresee GST to bring significant medium to long-term benefits to the Indian auto industry.

The road ahead

Investors will see a continuing evolution of regulatory structures as the Indian automotive sector continues to grow and mature. The power struggle surrounding the Delhi diesel ban is just one example of the highly complex political-economic environment that often leads to uncertainty and business risks. A key factor that warrants close attention is implementation; differences at the state or even district level are not uncommon and present one of the most frequent challenges to our clients in India.

While hurdles clearly remain – infrastructure, skilled labour and R&D investment – Control Risks' outlook on the Indian automotive sector is positive. Upcoming legal and regulatory changes constitute risks but they also present opportunities – and investors who identify trends early can benefit from significant first-mover advantages.

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With 20 years of experience in India, strong local networks and robust sector expertise, Control Risks is the ideal partner to lend investors the foresight, flexibility and familiarity required to successfully navigate the complexities of the Indian automotive sector.

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