

India's retarded retail sector

Retailers should give up self-defeating beliefs about the profitability of tax evasion and bargaining with customers

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In the recent controversy about foreign direct investment (FDI) in the retail sector, the conspicuous failure of Indian entrepreneurs to modernize the industry has remained largely unaddressed. An efficient supply chain linking producers to consumers calls for a commercial code, business relationships, reputation of products and their brands, transportation, warehousing, financing, and software to operate and control the system. All these elements are already present or available in India, so why does India need a Walmart to lower the prices its consumers pay? And therein lies a tale.

Efficient mass merchandising calls for a large scale with hundreds if not thousands of outlets. Control of large networks requires stocking and pricing policies, software for managing logistics and transactions, as well as databases in which all goods and related events throughout the network, including billions of transactions, are captured and permanently recorded in a traceable and auditable manner. Integrity of these databases, being crucial for the ability of the management to identify bottlenecks and remove inefficiencies, is jealously guarded.

The system that serves to manage large retail organizations is also convenient for the tax payment and collection. Complete record of goods, cash, and transactions facilitates easy and fast preparation of internal and external financial reports as well as returns for sales, income and any other taxes. The system creates a difficult-to-manipulate audit trail making it easier for management to track any misappropriation of inventories or cash handled by

thousands of employees in locations spread across the country.

Further, it is easier for the independent auditors of financial reports (for publicly held firms) and for the government tax auditors to verify the records. Integration of large-scale operations and the information system designed to serve them is essential to their efficiency. For example, this system may enable a chain with thousands of stores to track the sale and inventory of each of their tens of thousands of items in real time, and request vendors to ship additional supplies to locations as needed within minutes.

Efficient operation of such an integrated system has two simple requirements: a pricing policy and tax payment. Without a pricing policy, each interaction with customers presents an opportunity to bargain. Bargaining can allow the seller to price discriminate (charge a higher price from customers who place a higher value on the good) and thus earn higher profits.

However, in a chain of stores where the owner cannot be present to do the bargaining with every customer, the risk of moral hazard associated with delegating the bargaining function to hired employees becomes too large.

Most Indian retailers either do not post their prices, and even when they do, the prices are subject to bargaining by customers who know better. Retailers think that the advantages of extracting a higher price from some customers outweigh the consequences of limiting themselves to a mere handful of stores managed by trusted employees or family members.

Payment of sales, income and



other taxes is an even greater barrier to modernization of retail industry in India. Not recording purchase and sale transactions, or recording them selectively in two separate sets of books, is a common method of evading taxes in many parts of the world. India is no exception.

Modernization of retail industry, accompanied by integrated and transparent information systems, makes it easier for governments to collect their due. An operator of a large chain who asks the employees to evade taxes becomes susceptible to pressure and blackmail by employees. It is not surprising that entrepreneurs often take the simpler route of keeping their operations small enough to manage through direct personal supervision.

Indian retailers can and should break out of the self-defeating confines of the beliefs about the profitability of tax evasion and

bargaining with individual customers. When they do, they can earn much larger total profits on higher sales volume from expanded operations in spite of narrower margins. Narrowed margins, combined with economies of scale of operations, and expanded bargaining power vis-a-vis producers will enable them to lower the price to consumers. Consumers will respond to lower prices by buying more, and increasing total profits of retailers.

It may take the entry of foreign retailers to alter the beliefs of Indian retailers about their business model. Once that happens, Indian retailers can be expected to develop modern chains of their own; they may even take their business abroad. If they do, Walmart may have to watch out for its own territory.

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