Strategy In-Depth

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India FY08 Budget Preview

An Interesting Backdrop – Growth, Inflation, Politics

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- Declining market significance of Budget — Structural changes to tax policy have already been done over the last decade. Tax changes are more subtle now, while mere policy intentions are taken with a pinch of salt given realities of coalition politics, limiting the Budget's immediate market significance.

- Budget backdrop: Growth, Inflation, Politics — The FY08 Union Budget will be presented on 28 Feb. Unprecedented economic growth, buoyant tax collections, better-than-budgeted fiscal deficit and strong corporate profitability set the positive tone. On the flipside, rising inflation is an economic as well as political issue. Any tough measures will probably have to be looked at in the context of upcoming UP state elections, which are politically significant.

- Potential measures — Buoyant tax collections will likely embolden the government to opt for reductions in import and excise duties to tackle inflationary pressures. Tax surcharges on personal and corporate taxes may be removed. Service tax net will continue to widen. IT/ITES sectors' tax exemptions may be extended. More clarity on SEZ taxation policy. Focus on rural and infrastructure sectors to continue. Improved access to pension funds for local capital markets.

- No change in our strategy & portfolio positioning — Notwithstanding all the focus on inflation, the Budget will have to retain a growth-supportive policy. We retain our visible growth, large-cap bias, with Overweights on IT services, Telecom, Capital Goods and Consumer. We are also positive on Cement and Media. We continue to remain Underweight on rate/credit-sensitive sectors – Autos and Banks. Energy, Materials and Pharmaceuticals are our other Underweights.

See Appendix A-1 for Analyst Certification and important disclosures.

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India FY08 Budget Preview

Declining market significance. Expectations are low

The next Annual Union Budget is scheduled to be presented on 28 February. Structural changes to tax policy have already been done over the last decade. Tax changes are more subtle now, while mere policy intentions are taken with a pinch of salt given realities of coalition politics, limiting the Budget's immediate market significance. Nevertheless, it still needs to be watched in case of one-off policy measures. The market's modest move pre-Budget (up just 2% in last one month) indicates that expectations from this year's Budget are also low thus far, with much of the market's attention in 2007 having been focused first on earnings, then inflation/interest rate rise. Low expectations are welcome, as usually the Budget finds it difficult to live up to high expectations, resulting in significant corrections post the Budget.

Figure 1. Sensex Price Performance Pre and Post Budget (Percent)

	Pre-Budget (%)		Post-Budget (%)	
Budget date	1mth	2mth	1mth	2mth
15-Mar-95	(2.5)	(5.7)	1.9	(8.3)
22-Jul-96	(3.0)	3.3	(11.0)	(12.1)
28-Feb-97	1.3	18.4	0.3	4.8
1-Jun-98	(9.1)	(8.2)	(11.3)	(11.8)
1-Mar-99	7.9	15.1	4.6	(5.6)
29-Feb-00	2.1	10.3	(6.3)	(14.5)
28-Feb-01	(1.9)	8.0	(10.8)	(19.4)
28-Feb-02	7.4	11.9	(2.6)	(5.4)
28-Feb-03	0.5	(3.4)	(5.1)	(10.6)
8-Jul-04	(2.4)	(14.6)	7.3	9.4
28-Feb-05	4.6	2.3	(3.0)	(6.4)
28-Feb-06	5.1	12.0	6.9	14.3
19-Feb-07*	1.9	8.0		

Source: Powered by dataCentral *Price Performance up to 19 Feb 2007

Budget Backdrop – Growth, Inflation, Politics

This year's Budget is being presented in an interesting and mixed backdrop. Setting the positive tone are: unprecedented economic growth (+9% GDP growth last few quarters); buoyant tax collections; and a likely better-than-expected fiscal deficit for FY07. On the flipside, rise in inflation has become a key economic as well as political issue. Plus, the politically significant UP state elections soon after the Budget (sometime in April) will probably limit the maneuverability as far as any potentially unpopular measures are concerned.

So, we expect to hear and see a lot about fighting inflation, in addition to the usual emphasis on infrastructure and rural sectors. On the fiscal side, some steps have already been taken in recent weeks to reduce inflation (e.g., reduction in import duties on cement and metals). The recent unjustified (economically that is, given trends in international oil prices and oil marketing margins) cut in retail gasoline and diesel prices will also help in getting headline WPI down.

The real battle against inflation though has to be fought elsewhere and does not have much to do with the Budget – i.e., slowing down credit expansion (RBI has already moved aggressively there), removing bottlenecks to increased supply in areas seeing significant price spikes (i.e., real estate, wage inflation).

Buoyant tax collections will give elbow room

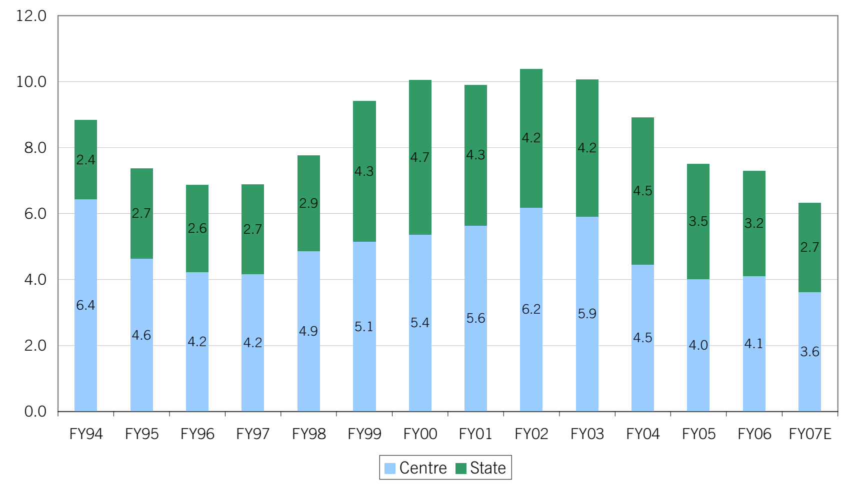
Robust economic growth and corporate profitability have meant tax collections have been running well ahead of Budget, up 38% yoy during the Apr-Dec 06 period. Our economist Rohini Malkani expects FY07 central fiscal deficit to come in at about 3.6% of GDP – surpassing the government's target of 3.8% due to buoyant tax collections; and expenditure containment.

Figure 2. Buoyant Tax Collections May Induce Some Tax Reductions (Rs bn)

	Apr-Dec 05	Apr-Dec 06	% YoY	% Of Budget
Corporate Taxes	605	939	55.2	70.6
Income Taxes	365	464	27.0	60.0
Customs Duties	479	637	32.9	82.6
Excise Duties	672	718	6.8	60.3
Others	187	308	64.3	86.2
Gross Taxes	2,308	3,065	32.8	69.3
Devolvement to States	612	732	19.5	63.7
Surcharges	9	12	30.7	
Net Taxes	1,687	2,322	37.6	70.9

Source: Citigroup Investment Research

Figure 3. India's Fiscal Deficit Trend (Percent GDP)



Source: Budget Documents, RBI

Potential taxation measures

With India's low tax-GDP ratio, we expect tax reforms to continue in FY08. While we do not expect to see any major changes in the taxation structure, we could see a further widening of the tax net, including more services and the continuation of the process of rationalizing customs and excise duties to ASEAN levels; phasing out tax exemptions; an effort to move towards a harmonized goods and services tax (GST), which would involve a phasing out of the central sales tax (CST).

We expect the Budget to maintain the trend of import duty reductions (with peak import tariff may be falling from 12.5% to 10%). Import liberalization in case of certain food products to contain domestic price spikes will also be key and it probably need not be part of the Budget.

Excise duty reductions will probably have more of an immediate impact on lowering prices, as these are typically passed through immediately. We expect excise duty reductions for cars and utility vehicles (from 24% to 16%). There could be excise reductions and other tax incentives for the food processing sector, to both contain inflation and give a lift to a sector directly connected with the rural economy.

While we do not expect any changes to main personal and corporate tax rates, surcharges and cess could be reduced as a kind of goodwill gesture. This might reduce peak tax rates by 2-3%.

There is a stated intention on reducing tax exemptions for corporate sector and that is set to continue. However, given IT / ITES sectors' growth significance, its tax exemptions may be extended beyond 2009, which will be a positive surprise for the sector. There could also be attempts to resolve fiscal and tax exemption related issues for SEZs.

Other potential policy initiatives

Pension reforms through the PFRDA Bill may be given another push, although Left opposition remains a stumbling block there. As part of the rural emphasis, there could be positive measures for fertilizers, irrigation, biofuels, and microfinance. On the infrastructure front, steps are likely to encourage the public-private-partnership model. On infrastructure and general financing side, there could likely be measures to further incentivise savings via infrastructure bonds, use of forex reserves to fund development, and liberalization in the end-use of external commercial borrowings (ECBs).

Other potential sector initiatives

As mentioned earlier, excise duties on cars and utility vehicles may be cut from 24% to 16%, which would be positive for players in that sector.

In the consumer sector, we expect an increase in cigarette excise duty. Anything up to a 5-7% increase would be manageable, beyond which there could be a volume growth impact. The consumer sector could benefit from reductions in import and excise duties on inputs.

In textiles, we expect the extension of the TUF scheme, currently expiring on March 2007.

For the oil sector, we expect cuts in import and excise duties to compensate oil marketing companies for the hit they have had to take recently due to retail fuel price cut to support the inflation containment cause. For airlines, there have been major demands from the industry to reduce heavy sales tax on aircraft fuel (ATF, from 25% to 4%) and we cannot rule out some relief there.

No choice but to remain growth focused, despite inflation concerns

India's policy makers must be aware that growth is the ultimate cure for the major challenges facing India (poverty, unemployment and fiscal deficit). So we expect the growth focus to continue in government policy through this Budget as well.

Appendix A-1

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