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India Economics

What Will Be the Focus of Budget F2008?

What's new: On February 28, the Ministry of Finance is scheduled to present the annual central government budget, which sets the tone for the direction of policy reforms over the coming year.

Conclusion: Apart from addressing fiscal management as a broader issue, the government has traditionally used the budget as a platform for relaying the measures it aims to take to address the pressing macro issues. We believe that F2008 budget measures would centre on the three key macro themes: (a) inflation control, (c) infrastructure, and (c) enhancing social objectives.

Implications: On an overall basis, we expect the budget to take a few more steps in the right direction. However, we believe that many of the critical macro challenges for the country need to be addressed outside the budget and in this context the budget per se has limited scope for pushing forward structural reforms.

For important disclosures, refer to the Disclosure Section.

What Will Be the Focus of Budget F2008?

Summary

The Ministry of Finance is scheduled to present the annual central government budget on February 28. Apart from addressing fiscal management as a broader issue, the government has traditionally used the budget as a platform for relaying the measures it aims to take to address the pressing macro issues. We believe that F2008 budget measures will centre on the three key macro themes: (a) inflation control, (c) infrastructure, and (c) enhancing social objectives.

Assessing the Success of Fiscal Management

In line with the last three years trend, the Central government's headline deficit is likely to reduce further to 3.3% of GDP during the 12 months ended March 2007, well within the target implied by the Fiscal Responsibility and Budget Management Act. The government has been able to cut its fiscal deficit from a peak of 6.2% in F2002 primarily on account of higher ratio of tax to GDP. We believe that a significant part of the improvement in tax to GDP is cyclical, reflecting a leveraged, growth cycle supported by global liquidity and low real interest rates. Indeed, most of the increase in tax to GDP is due to higher corporation taxes because of higher profits. Moreover, if we add the off-balance sheet oil subsidy of 1.1% of GDP, the fiscal deficit would be at 4.5%. We believe for a sustainable reduction in deficit there is a need to reduce non-interest revenue expenditure, which has increased by 0.6% percentage point of GDP since F2002. Indeed, we would rate the improvement in the fiscal management to be less than satisfactory. In the F2008 budget, we do not expect any major progress on expenditure reforms, the long-standing issue that has led to a sticky fiscal deficit problem.

Macro Themes That Will Influence Budget Measures

We believe that the government is occupied with working out measures to sustain the current high growth but at the same time it is also initiating steps to address the needs of the lower and middle income population making the growth inclusive in nature. In this context, we believe that budget measures will focus on following three macro objectives:

(a) Inflation Control: Through Indirect Tax Rate Cuts

Wholesale price index (WPI)-based inflation rate (provisional) has accelerated to 6.73% during the week ended February 3, 2007 (from 5.58% six weeks ago), well above the RBI's comfort zone of 5-5.5%. Analysis of price trends for various WPI components indicates that a major part of the recent acceleration in overall inflation is due to manufacturing products. We believe that the budget will attempt to take short-

Exhibit 1

India: National Fiscal Deficit

(As % of GDP)	F2004	F2005	F2006	F2007E
Central Fiscal Deficit	4.5%	4.0%	4.1%	3.4%
State Fiscal Deficit	4.5%	3.5%	3.2%	3.3%
Sub-total	**8.9%**	**7.5%**	**7.3%**	**6.7%**
Inter-government adjustments	-0.4%	0.0%	0.1%	0.1%
Combined Headline Deficit	**8.5%**	**7.5%**	**7.4%**	**6.8%**
Major Off-budget items				
---Oil Subsidy	0.2%	0.6%	1.1%	1.1%
---Electricity Subsidy	0.8%	0.8%	0.7%	0.6%
Overall Fiscal Deficit	**9.5%**	**8.9%**	**9.2%**	**8.5%**

Source: RBI, Economic Survey, Ministry of Finance, Morgan Stanley Research; E= Morgan Stanley Research Estimates

Exhibit 2

Reconciliation of Change in Central Govt deficit

1] Overall fiscal deficit – including off-balance sheet oil subsidy (F2002)	**6.2%**
Increase in gross tax collections	3.4%
-- Corporate taxes	2.2%
-- Personal income taxes	0.6%
-- Customs Duty	0.3%
-- Excise Duty	-0.3%
-- Service Taxes	0.8%
Higher allocation to states	-0.5%
Increase in net tax collections	**3.0%**
Decline in non-tax receipts	-1.1%
Decline in capital receipts (privatization and recoveries of loans)	-0.6%
2] Total increase in receipts	**1.2%**
Decline in capital expenditure	-0.9%
Decline in interest payments	-1.3%
Increase in non-interest revenue expenditure	0.6%
3] Total increase in expenditure	**-1.5%**
4] Increase in off balance sheet oil subsidy	**1.1%**
5] Overall fiscal deficit - including off-balance sheet oil subsidy (F2007E) [1-2+3+4]	**4.5%**

Source: RBI, Morgan Stanley Research; E= Morgan Stanley Research Estimates

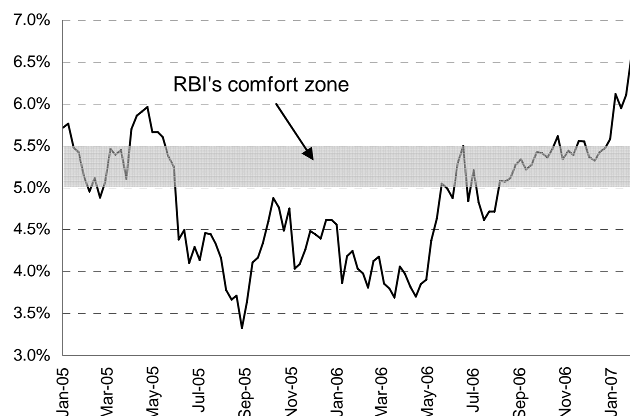
term measures to reduce the inflationary pressure by cutting customs and excise tariff for manufactured products. We believe there could be across the board cuts in peak tariff from 12.5% to 7-8% taking it closer to the target of 6-7% (the current ASEAN tariff rates). In our view, the sustainable solution would be to create the right business environment so that supply side response (productive capacity creation) is adequate to meet the acceleration in demand growth. However, addressing this weakness remains a challenge and requires a quick concerted policy response to bring about a major change in business environment, particularly infrastructure and the overall administrative framework.

(b) Infrastructure - Particularly for Rural Areas
As we have been highlighting for a while, one of the key reasons for India's slow response in increasing productive capacity has been less than optimal government response to improve the business environment. In this context, infrastructure development is the most important anchor for a quick response from the corporate sector to add productive capacity. Both the central and state governments have announced a set of measures over the last three years to increase infrastructure spending. This we believe has helped accelerate India's total infrastructure to US$34 billion (3.9% of GDP) in F2007 from US$ 17.8 billion (3.1% of GDP) in F2004. However, we believe that to sustain 8-9% GDP growth, there is a need to increase infrastructure spending to 7-8% of GDP. We believe that the government will move further in the right direction in the coming budget by announcing measures to promote infrastructure investments.

Within the overall infrastructure push, the budget is likely to make a bigger push for government spending on rural infrastructure. Although, the private sector has been forthcoming for funding urban infrastructure, the rural infrastructure spending (except telecom) has not witnessed any significant improvement so far. We believe that there is unanimous opinion amongst the policy makers that the rural infrastructure investments by the public sector, which have been woefully lacking, need to increase. We expect the budget to increase allocation for rural infrastructure spend as well tax concessions for the corporate sector investing for the purpose. This measure will also be necessary for addressing the emerging longer term challenge on food inflation as lack of infrastructure investments has caused deceleration farm output growth.

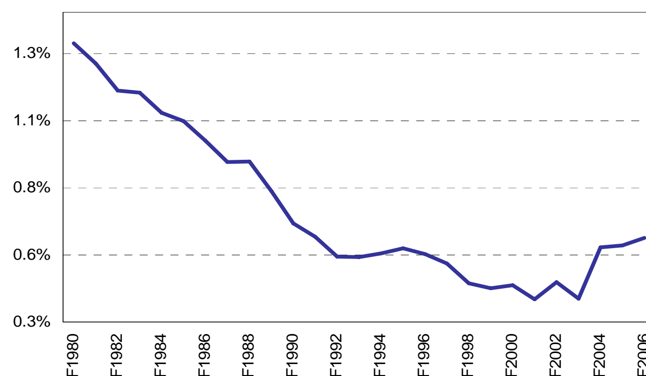
(c) Enhancing Social Objectives: With Higher Budget Allocation to Education and Health
Social development has continued to be among the most

Exhibit 3
Inflation Rate (WPI, % YoY)



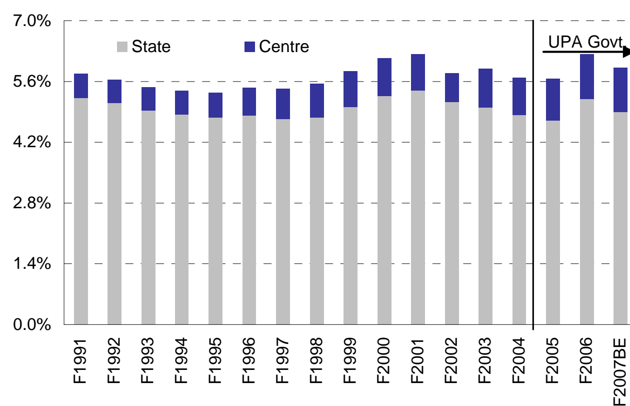
Source: RBI, Morgan Stanley Research

Exhibit 4
Public Capital Spending on Agriculture



* Taken as sum of food, power and fertilizer subsidies.
Source: Economic Survey of India, RBI, CMIE, CSO, Morgan Stanley Research

Exhibit 5
Social Sector Spending (As % of GDP)



Source: RBI, Morgan Stanley Research; BE= Government Budget Estimates

important issues gaining the attention of policymakers over the past three years (since the UPA government assumed power). This is reflected in the acceleration in the central government's social sector spending over the past three years to an annual average rate of 21% as compared with an average 10% in the preceding five years. The key area that has seen acceleration in spending has been education. This acceleration has in turn been aided by the 2% education cess levied on tax collections by the Central Government. However, our concern is that the state governments, who account for about 80% of total spending, have witnessed a much slower growth in their allocation. Their spending on the social sector has grown by 15% in the past three years (just above nominal GDP growth of 14%) as compared with 9% in the preceding five years. We believe that the states need to concurrently accelerate their spending on the social sector to ensure that the government is able to reach its target spending of 8-9% of GDP on education and health as compared with its current spending of 5.9% of GDP. In this year's budget, we expect the Central government to continue its push for spending on social development, particularly with regards to education and health.

Expectations on Sector Specific Measures

A bottom-up aggregation of our analyst expectations indicates that the budget will likely have a benign impact on most of the sectors, barring a few tax related tweaks. The sectors where positive announcements are expected in the budget include – banks (incentivizing deposit mobilization via income tax breaks), agrochemicals (thrust on agriculture and reduction of customs duty), automobiles (excise and customs duty cuts), infrastructure (focus on funding, further clarity on key projects) and oil & gas (potential reduction in regulatory uncertainty). The metals sector is the only one where negative announcement is expected in the form of customs duty cuts owing to inflation fears. The sector specific measures have been detailed in Exhibit 6 on the following page.

Bottom Line

On an overall basis, we expect the budget to take a few more steps in the right direction. We expect the government initiate a meaningful cut in indirect taxes and increase allocation for infrastructure and social development expenditure, such as on education and health. However, we have limited hopes for the introduction of public expenditure reform in the current coalition politics environment. Similarly, on policy reform, we see little likelihood of any major push for privatization and foreign direct investment (particularly multi-product retail business and insurance sector). We believe that many of the critical macro challenges for the country need to be addressed outside the budget and in this context the budget per se has limited scope for pushing forward structural reforms.

Exhibit 6

Bottom-Up Sector Specific Expectations from Our Analyst Team

Sector	Budget Expectations
Agrochemicals	- Reduction in custom duty of raw materials (chemicals). This would be a positive for agrochemical companies like UPL that source around 35% of raw materials through imports. - Policy measures encouraging investment in agriculture, improvement of agricultural productivity. This could indirectly benefit agrochemical companies through higher potential demand for crop protection products.
Airlines	- We expect the government to announce a lower customs/excise charge on aviation turbine fuel
Autos and Autos Parts	- Excise duty reduction on mid-size and premium cars from 24% to 16% - Custom duty reduction on auto parts from 12.5% to 5% - Tax exemption on R&D expenses to be raised from 125% to 150%
Banks	- Deposit mobilization by banks may be given priority in this budget, hence steps like restoration of the earlier provision for tax exemption on interest income under Section 80L may be taken. - Relaxation in the lock-in period for savings under Section 80C. Currently only deposits of more than 5-year lock-in can get benefit under Section 80C. This may be reduced to 3 years. - Tax-exempt status may be given to long-term infrastructure bonds raised by commercial banks.
Cement	- Contrary to market expectations, we do not expect a cement export ban announcement by the government and expect the budget to be neutral for the cement sector
Consumer	*Processed Foods industry* - Rationalize and lower indirect taxes to promote processed foods consumption and production. - Potential reduction in peak customs duty could impact cost of packaging materials and various other chemical inputs used in the manufacture of Home and Personal Care categories. *Cigarettes* - The government is contemplating to enable states to levy state tax (i.e. VAT) on cigarettes. It could give guidelines on issues such as rate of taxation and methodology to be used for calculation such VAT.
Healthcare	- The key announcement for the pharmaceutical sector is the extension of the 150% weighted deduction for research spend, which ends in F2007. - The companies' are also asking for the expansion in the span of the research expenses covered under this deduction to include clinical spend and patent filing spend. Aside for this, the Budget is expected to have little impact on Pharma sector.
Infrastructure	- The government is trying to work out various innovative funding options for infrastructure development. Given the large forex reserve buildup, the government might in the budget allow their use for financing infrastructure spending. - We expect the Government to provide clarity on the total number of Ultra Mega Power Projects (seven based on earlier announcements) it plans to introduce and a broad timeline for the completion of the bidding process. - The Budget may also relax norms pertaining to withholding tax on interest payments on external commercial borrowings which may in turn make infrastructure projects more attractive to private sector developer by reducing interest costs.
IT Services	- The status of tax exemptions (Sections 10A/10B) for companies operating in software technology parks is the only significant issue for the sector that the Budget can impact. The smaller companies have been asking for an extension (beyond F2010) as they will be unable to take advantage of the SEZ-related exemptions due to their size. Others such as Mr. Narayana Murthy, on the other hand, believe that the companies are very profitable and should pay taxes. Any modifications to the SEZ rules related to IT companies can also impact the sector. The most likely outcome in the Budget is status quo for the time being. - There could be some positive action taken by the government on the education front, related to engineering schools.
Metals & Mining	- With an eye on countering the acceleration inflation, import duty on steel may be cut from 5% to 2% or even zero though this measure will at best postpone price hikes by a month. On non ferrous metals too it may be cut to 2.5%. - We also feel that excise duty on both, steel as well as non ferrous metals, may be reduced from the current level of 16% to 12% which won't be negative for producers as this burden will be borne by the government.
Oil & Gas	- Formulation of a policy to:- 1) reduce the total subsidy in the system due to sale of sensitive petroleum products 2) Making clear the subsidy sharing mechanism. - Reduction of taxes (i.e. sales tax and excise duty) on sensitive products (diesel, petrol, kerosene and LPG) to reduce the incidence of subsidy in the system. - Reduction of cess, royalties and other taxes for Upstream players to increase investment as majority of India is still unexplored.
Property	- Continuation of Rs150,000 tax deduction spent as interest on home loans - Continuation of tax exemption under section 80 IB which allows full tax benefits for housing less than 1000 sq ft in metros and 1500 sq ft in non metros (approved by March 31, 2007)
Retailing	It is expected that the government will promote agricultural markets through enactment of the APMC Act in States, private participation in mandis, direct marketing and contract farming.
Sugar	- Unlikely to have any significant impact on sugar. - Potential reduction in excise duty in ethanol blended gasoline. This could be a positive for sugar companies as this is likely to encourage ethanol blending by oil companies. - In addition there is scope for other policy measures like tax concessions aimed at encouraging adoption of ethanol/investment in ethanol facilities.
Textiles	The expectation is that the government would allow the textile manufacturers to avail the option of full exemption of excise duty or payment of 4% excise without insistence of maintaining separate books of accounts for inputs

Source: Morgan Stanley Research

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