Economy

Sector coverage view	N/A

Budget FY2010 likely to spur infrastructure investment, go slow on fiscal consolidation

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- **Budget likely to keep GFD/GDP ratio in 6-6.5% range**
- **Expanded NREGP, Bharat Nirman likely to sustain stimulus to rural economy**
- **Infrastructure investments may get a boost through annuity-based schemes, funding of SPVs for financing equity component**
- **We expect tax cuts to stay, but disinvestment of Rs200 bn can help check deficits**

Gross Fiscal Deficit (GFD) likely at 6-6.5% of GDP for FY2010E

We believe the Union budget for FY2010 is likely to peg GFD/GDP ratio in the range of 6-6.5%. Since the budget-making exercise is still at a nascent stage, a clear idea of the fiscal gap is yet to emerge. We believe the government is likely to strive to keep GFD/GDP ratio in 6.0-6.5% band as higher than 6.5% on-budget deficit for the centre could (a) make the path of future fiscal consolidation that much more difficult and (b) be a negative with the financial markets, especially foreign investors and rating agencies. At the same time, a deficit lower than 6% of GDP is seen as hampering growth revival and coming in the way of government spending on rural safety nets.

- GFD/GDP ratio below 6% appears improbable as the UPA government is committed to push its mandate for inclusive growth agenda further by expanding National Rural Employment Guarantee Program (NREGP) and Bharat Nirman Yojana
- A 6-6.5% GFD/GDP is considered possible even with expanded coverage of NREGP with the carry-over of unused allocations from last year's budget
- A GFD/GDP exceeding 6.5% is seen as risking future consolidation and GOI is keen to find ways for additional resource mobilization, including disinvestment, to check the deficit from spinning out of control. A 7% GFD/GDP ratio is seen as potentially triggering negative reactions from important stakeholders in a globalized economy.

Combined deficit seen at about 10% of GDP

We believe it may be possible to contain the combined deficit of the Centre (including off-budget) and States to 10% of GDP as off-budget deficit could be restrained to about 0.5% of GDP with subsidies reforms. State governments' deficit, with some prudence, could be contained at about 3% of GDP in FY2010E. We understand that officials consider this wide fiscal gap a legitimate counter-cyclical policy that is being adopted by several countries across the globe. In our assessment, fiscal deficits in India should start correcting from FY2010E at a moderate pace (see Exhibit).

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Subsidies reforms may be difficult

There appears to be is serious consideration of subsidies reforms, but political constraints may still hamper progress therein. While substantive suggestions for reforms aimed at capping GOI's subsidy bill have been mooted, whether or not these get reflected in the forthcoming budget is a political call for policy makers. The proposals under consideration could possibly include:

- Capping fertilizer subsidies by capping the amount and fixing subsidy per kg of nutrients
- Deregulating prices of petrol and diesel, while retaining price controls on kerosene and LPG with modest price adjustments
- Making provisions for higher food subsidy bill while aiming at reasonable procurement policy

Boost to infrastructure may be key driver for the markets

The boost to infrastructure investments may be the key driver for the markets in the forthcoming budget. While a public policy debate remains, experts recognize that road projects have come to a standstill as they are not attracting sufficient interests from private sector under the existing scheme. We expect the budget to consider the following:

- Road projects on annuity-based BOT schemes rather than toll-based BOT schemes up to a certain amount.
- Support for the equity component of infrastructure investments by funding SPVs for the purpose through budgetary and extra-budgetary resources
- Part guarantee of debt for major infrastructure projects

The extent of contingent liabilities which may be borne may still limit the initiative on the above lines.

Near consensus that monetary policy easing may have run its course

The boost for infrastructure investment could turn out to be major growth driver, nevertheless, there is growing recognition in policy circles that options for further monetary policy easing have dried up. Though voices for yet another rate cut one persist, they are feebler than before. Our understanding is that many policymakers and influential economists now believe that further rate cuts are not necessary, nor can banks be forced to lend. They expect credit off-take to pick up only at the point where industry feels comfortable investing.

New fiscal stimulus may be limited to inclusive growth

Our view is that the government will limit itself to the three fiscal stimulus packages already undertaken. Apart from infrastructure investment initiatives which are likely to have limited immediate implications for current year deficit, the stimulus in the forthcoming budget may be limited to increased allocations for inclusive growth agenda. This would cover the NREGP, Bharat Nirman as well as some enhanced spending for urban poor. Spending on NREGP would go up because of added coverage as well as enhanced wage rates.

Tax cuts may not be rolled-back yet

A section of the experts believe that tax cuts have gone too deep while many suggest that GOI should not be in a hurry to roll-back tax cuts this year for the fear that it may nip in the bud any nascent recovery. They see the CENVAT and services tax reductions to have contributed to promote growth and keep inflation low in spite of 20% plus depreciation of the rupee. However, they remain worried that if GST doesn't get introduced next year and tax cuts remain it may find it difficult to contain fiscal deficits in FY2011. In our view, GST is unlikely to be introduced in April 2010 as it involves a difficult process of converging several rates, computerizing CENVAT and services tax information and a constitutional amendment to alter tax powers for both centre and states.

In our view, the removal of Fringe Benefit Tax (FBT) may be considered as the revenue from the tax is disproportionately small to costs associated with collection that are borne by firms as well the government. Changing the Securities Transaction Tax (STT) or the capital gains tax may prove to be more difficult, but could be considered as well.

Disinvestment target of over Rs200 bn may be difficult

Our understanding is that the GOI is determined to push disinvestments to keep the fiscal equation under control. However, we believe that larger than Rs200 bn disinvestment target for FY2010 maybe impractical given its commitment for small-ticket stake sale, largely through the strategic investor route. We expect the budget to spell-out a medium-term agenda on disinvestment, perhaps targeting disinvestment close to Rs1 tn over the entire five-year term of the government. A medium-term strategy on tax policies may also be considered with a view to bring about fiscal consolidation from FY2011 onwards.

Exhibit : Fiscal deficit likely to correct at a moderate pace

GFD/GDP ratios in India, March fiscal year-ends, 2007-2010E (%)

	2006A	2007A	2008A	2009RE	2009E	2010BE	2010E	2011E
Centre	4.1	3.4	2.7	7.8	8.2	5.5	6.9	6.9
on-budget	4.1	3.4	2.7	6.0	6.2	5.5	6.4	5.8
off-budget	NA	NA	NA	1.8	2.0	NA	0.5	1.1
State	2.5	1.9	2.3	2.7	2.7	NA	3.1	2.6
Total	**6.6**	**5.3**	**5.0**	**10.5**	**10.9**	**NA**	**10.0**	**9.5**

Note: (1) Centre's on-budget deficit for FY2009 is expected to rise from 6.0% RE in the interim budget
(2) off-budget liabilities were sizeable even before FY2009, though in absence of clear accounting it is difficult to crystallize them.

Source: Ministry of Finance, RBI, Kotak Institutional Equities estimates

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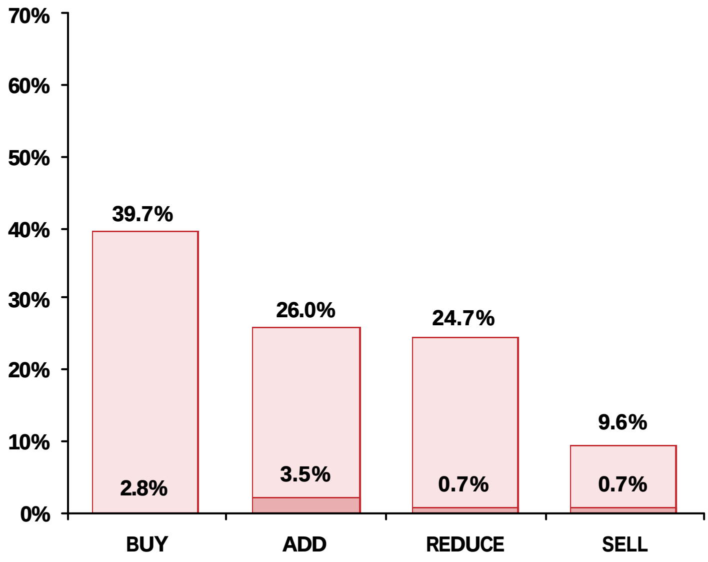

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Source: Kotak Institutional Equities

As of March 31, 2009

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