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India: Preview of interim budget and fiscal finances in FY10

In the outgoing government's interim budget on February 16, we expect only a modest amount of genuine fiscal stimulus, while the central government's fiscal deficit (excluding off-budget items) for FY09 (year ending March 2009) is likely to be revised up to 6.1% of GDP from the originally budgeted 2.5%. In our view, this will place an even greater onus on monetary policy stimulus and is one of the key reasons why we expect the Reserve Bank of India to continue cutting rates aggressively.

India's general election is due to be held before May 2009, which means the incumbent government has to present an interim budget or, as it is called in India, a "vote on account" on February 16. In a vote on account, the government seeks parliament's vote (or approval) to spend enough money to meet its essential expenses for part of the next financial year, until the new government presents a final budget (after the election). This situation does not provide for new spending schemes or any change to the direct tax structure, given the belief that a new government should have the opportunity to set its own expenditure plans and revenue sources in its first budget once the election is over (see Box 1 for further details).

However, with a slowing economy and given the lags involved in implementing fiscal spending, we expect the outgoing government to allocate sufficient resources to various departments in order to help them identify future projects. This is likely because once the election is announced, the election code of conduct means fiscal policy tends to enter a period of limbo. No new spending will be forthcoming until the new government takes office.

Possible policy announcements

The interim budget is, in our opinion, likely to see an increase in total planned expenditure. On the tax front, we expect to see changes in indirect tax rates to aid specific, more vulnerable sectors of the economy, while we believe any change regarding direct taxes will be limited to procedure and administration.

- **Increased planned spending**: As part of the fiscal stimulus measures, we expect planned expenditure to increase by 14.2% in FY10 over the revised estimates for FY09. Most of this additional spending is likely to be targeted at the ruling United Progressive Alliance (UPA) government's flagship schemes in rural areas and the infrastructure, health and education sectors. Given the rise in job losses, we expect the national rural employment guarantee scheme and skill-development programmes to receive larger allocations of funds.

- **Export incentives**: The government is likely to announce further interest rate subsidies for exporters and an increase in duty drawback rates for labour intensive sectors, such as textiles, gems & jewellery and handicrafts.

- **Other sector-specific measures**: Worst affected by the ongoing slowdown are the housing and auto sectors. To boost demand for housing, the government could increase the tax deduction allowed for interest payments on home loans from INR150,000 to INR200,000. Excise duties could be reduced on commercial vehicles and auto components while protection of the steel sector via import duties could be increased.

- **Administrative change on direct tax**: We do not expect any change to direct tax rates, but measures to simplify procedure and improve administration, such as centralized assessment of income tax returns, are likely.

- **Election manifesto**: The government may take this opportunity to push its election manifesto. The speech is likely to mention the government's achievements and could also include its intentions on economic policy (should it form a government after the election).

Substantial fiscal slippage in FY09

We expect a major upward revision of the size of the FY09 central government fiscal deficit (excluding off-budget items) to 6.1% of GDP from an originally budgeted 2.5%. Around 2.3pp of the increase is due to higher expenditure during the year, particularly on higher subsidies, pay commission hikes and the farm loan waiver (Exhibit 1). However, revenues also disappointed during the last two quarters of FY09: corporate tax collections for April-

December rose just 11.9% against a budgeted gain of 21.6% for the year; income tax revenue rose only 6.9% versus a planned 16.9%; customs duty was up 11.1% versus an 18.0% target; and excise duty generated only a 2.2% rise in income compared to a 7.8% plan. Only services tax collections were buoyant, rising 25.5%. Moreover, we estimate that the central government's off-budget deficit stood at around 1.5% of GDP in FY09, due to issuance of oil and fertiliser bonds, taking the centre's total fiscal deficit (on- and off-budget) to 7.6% of GDP. Including the fiscal deficit of states, estimated at 2.6% of GDP in FY09 versus the budgeted 2.1%, the general government fiscal deficit (including off-budget items) likely rose to 10.2% of GDP in FY09 from 6.2% of GDP in FY08.

Exhibit 1. Central government's fiscal deficit, FY09 – Nomura estimates

% of GDP	FY09 (Budget estimate)	FY09 (Nomura forecast)	Slippage (Budget – Forecast)
On-budget fiscal deficit*	**2.5**	**6.1**	**3.6**
A. Plan expenditure	**4.5**	**4.8**	**0.4**
B. Non-plan expenditure	**9.3**	**11.3**	**2.0**
Interest payments	3.5	3.6	0.1
Defense expenditure	1.1	1.3	0.2
Food subsidy	0.6	0.8	0.2
Fertiliser subsidy	0.6	1.4	0.8
Debt relief to farmers	0.0	0.3	0.3
Other non-plan expenditure	1.5	1.7	0.2
Other non-plan revenue expenditure	0.2	0.4	0.2
Other non-plan capital expenditure	1.9	1.8	-0.1
Total Expenditure (A+B)	**13.8**	**16.2**	**2.3**
C. Revenue receipts	**11.1**	**10.0**	**-1.1**
Tax revenue (net)	9.3	8.4	-0.9
Non-tax revenue	1.8	1.6	-0.2
D. Capital receipts	**2.7**	**6.1**	**3.4**
Recoveries of loans	0.1	0.1	0.0
Other receipts	0.2	0.0	-0.2
Borrowings and other liabilities	2.5	6.1	3.6
Total Receipts (C+D)	**13.8**	**16.2**	**2.3**
Memo: Off-budget items	**0.0**	**1.5**	**1.5**
Oil bonds	0.0	1.2	1.2
Fertiliser bonds	0.0	0.3	0.3

**Fiscal deficit = Total expenditure –(revenue receipts+ recoveries of loans + other receipts)*

Source: Budget documents, CEIC and Nomura.

Expectations for FY10

The recent trends of tax slippage, civil service pay hikes and the need for greater government spending will continue into FY10 (year ending March 2010). However, the subsidy burden should be lower in FY10 than in FY09 due to lower commodity prices. We expect the centre's fiscal deficit (excluding off-budget items) to narrow to around 5.2% of GDP in FY10 versus an estimated 6.1% of GDP in FY10 (see Exhibit 2 and below for details).

Revenue collection: We expect net tax revenue collections to decrease to 8.2% of GDP in FY10 from 8.4% in FY09, largely on account of reduced excise and customs duty collections because of weaker economic growth and more fiscal stimulus through tax cuts. We expect direct tax collection to remain unchanged as a share of GDP in FY10. On the non-tax revenue front, we expect receipts to rise by about 0.2pp of GDP in FY10, largely assuming the auction of the 3G telecom licence takes place.

Expenditure targets: We are building in an increase of 14.2% y-o-y in planned expenditure in FY10, equivalent to 5.1% of FY10 GDP, up from 4.8% of FY09 GDP. Most of this increase in spending is likely to be directed at infrastructure, rural and social sector schemes.

On non-planned expenditure, we expect spending to fall to 10.2% of GDP in FY10 from 11.3% in FY09, largely because of a lower fertiliser subsidy burden in FY10 of INR300bn versus INR760bn in FY09. However, we expect food subsidies to remain high at around INR350bn in FY10, because of government support for the price of food grains and a likely increase in food procurement. Civil services pay hikes of around INR360bn and a farm loan waiver of INR150bn (which we have included in the subsidy component) are also due to add to non-planned expenditure. We expect commodity prices to remain at low levels, and so we do not forecast any significant off-budget oil or fertiliser bond issuance in FY10. An increase in commodity prices remains a risk to this view.

Exhibit 2. Central government's fiscal deficit, FY10 – Nomura forecasts*

% of GDP	FY06	FY07	FY08	FY09	FY09	FY10
	Actual	Actual	RE	BE	Forecast	Forecast
1. Revenue Receipts (2+3)	**9.6**	**10.5**	**11.1**	**11.1**	**10.0**	**10.0**
2. Tax Revenue (net)	**7.5**	**8.5**	**9.1**	**9.3**	**8.4**	**8.2**
Corporation tax	2.8	3.5	3.9	4.2	3.8	3.8
Income tax	1.6	1.8	2.5	2.5	2.1	2.1
Customs	1.8	2.1	2.1	2.2	2.1	1.7
Union Excise Duties	3.1	2.8	2.7	2.5	2.3	2.2
Service Tax	0.6	0.9	1.1	1.2	1.2	1.3
3. Non-tax Revenue	**2.1**	**2.0**	**2.0**	**1.8**	**1.6**	**1.8**
4. Capital Receipts (5+6+7)	**4.4**	**3.8**	**3.9**	**2.7**	**6.1**	**5.4**
5. Recoveries of Loans	0.3	0.1	0.1	0.1	0.1	0.1
6. Other Receipts	0.0	0.0	0.8	0.2	0.0	0.1
7. Borrowings and other liabilities	4.1	3.6	3.0	2.5	6.1	5.2
Gross market borrowing	3.7	3.5	3.3	2.7	4.8	5.0
Less - Repayments	1.0	0.9	1.0	0.8	0.8	0.8
Net market borrowings	2.7	2.7	2.3	1.9	4.0	4.1
8. Total Receipts (1+4)	**14.1**	**14.3**	**15.0**	**13.8**	**16.2**	**15.4**
9. Non-plan Expenditure	**10.2**	**10.0**	**10.6**	**9.3**	**11.3**	**10.2**
10. On Revenue Account	9.1	9.0	8.7	8.3	10.2	9.2
11. Interest Payments	3.7	3.6	3.6	3.5	3.6	3.5
Subsidies	1.3	1.4	1.5	1.3	2.7	1.5
12. On Capital Account	1.0	1.0	1.9	1.1	1.1	1.1
13. Plan Expenditure	**3.9**	**4.1**	**4.4**	**4.5**	**4.8**	**5.1**
14. On Revenue Account	3.1	3.4	3.7	3.9	4.0	4.2
15. On Capital Account	0.8	0.7	0.7	0.6	0.9	0.9
16. Total Expenditure (9+13)	**14.1**	**14.1**	**15.0**	**13.8**	**16.2**	**15.4**
20. Fiscal Deficit {16-(1+5+6)}	**4.1**	**3.5**	**3.0**	**2.5**	**6.1**	**5.2**

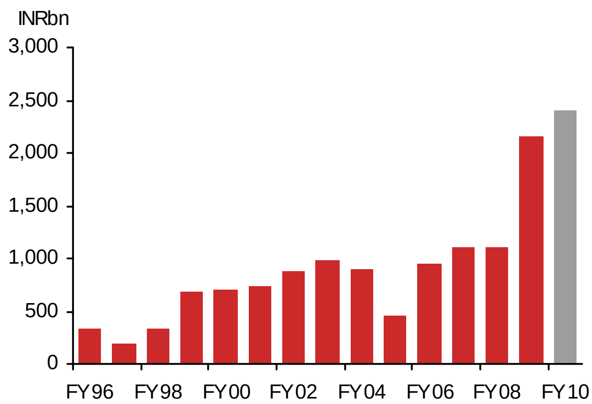
**BE: Budget Estimate; RE: Revised Estimates.*

Source: Budget documents, CEIC and Nomura.

Substantial government borrowing to continue into FY10

We forecast the central government's gross market borrowing to increase to INR2.9tr in FY10 from INR2.6tr in FY09, and net borrowing to rise to INR2.4tr from INR2.2tr (Exhibit 3). We expect net market borrowings to fund close to 80% of the fiscal deficit in FY10 versus 68% in FY09 (Exhibit 4).

Exhibit 3. Central government net market borrowings



Source: CEIC and Nomura estimates.

Exhibit 4. Financing of the central fiscal deficit

INRbn	FY08	FY09 BE*	FY09F	FY10F
Fiscal deficit	**1437**	**1333**	**3291**	**3058**
Net market borrowing	1107	1006	2164	2408
Short term borrowings	256	124	329	350
External assistance	100	110	112	120
Securities against small savings	-18	99	80	80
State provident funds	48	48	50	55
Draw-down of cash balance	-182	72	460	-5
Other Receipts (Net)	126	-126	96	50

**BE: Budget Estimate.*

Source: Budget documents, CEIC and Nomura estimates.

We believe the main reason for the higher dependence on market borrowings in FY10 is because the government started FY09 with surplus cash balances, which it likely used to partly fund the fiscal deficit in the early months of FY09. This will not be an option in FY10, so we expect to continue to see a reliance on net market borrowing through longer-dated government securities and on short-term borrowings through Treasury bills of about INR350bn for the year. We expect the remainder of the deficit to be funded through external assistance (INR120bn in FY10), securities issued against small savings (INR80bn) and other receipts (INR50bn). Unless the next government can raise more funds through disinvestment proceeds (privatisation) in FY10, which will depend on market conditions, the net dependence on market borrowings is likely to remain high.

Seeing through the fiscal veil

With elections around the corner, the government is likely to showcase next week's interim budget as a major fiscal initiative, but we expect only a modest amount of genuine fiscal stimulus given limited policy flexibility. The main purpose of the interim budget is to allocate sufficient resources before the general election (due no later than May 2009), given that once the election date is announced fiscal policy will largely enter a period of limbo. This will place an even greater onus on monetary policy as a stimulus to boost demand through further rate cuts and to identify the means to accommodate the government's higher market borrowing, including through more open market operations. The good news on the monetary policy side is that WPI inflation is abating rapidly and we expect it to continue to do so, falling from its current level of 4.4% y-o-y at end-January to a low point of -2.5% in August. With inflation no longer a concern and fiscal policy constrained, we expect the Reserve Bank of India to cut both the repo and reverse repo rates by 50bp each by the end of March, and to cut both rates by a further 100bp by mid-2009.

Bottom line: Expect a lot of fan-fare on fiscal issues next week, but in our view it is monetary policy that offers India the greatest hope for a policy stimulus at the moment.

Box 1: A vote on account

What is a "vote on account"?

A vote on account is a special constitutional provision by which the government gets parliament to vote to secure sufficient essential expenditure for part of the next financial year. This process of approval is sought because presenting, discussing, and then passing, a budget takes a long time – and in this case would extend beyond the April 1 start of the new financial year. Once a new financial year starts, the government cannot use any funds from the Consolidated Funds of India, without parliamentary approval.

Normally, a vote on account is taken every year for a period of two months. However, during an election year, the vote on account is obtained for a period of usually three or four months; after such time a new government is expected to be formed and the full budget presented.

How does a vote on account differ from a budget?

In a vote on account, the government may present the budget for the full financial year, but only seeks additional expenditure for a limited timeframe. There are also restrictions on the tax changes that can be announced. A budget may announce new schemes and changes in the tax structure of the economy, and has no constraints on receipts and expenditure.

What the government can (and can't) announce in a vote on account

The government can announce its *intentions* related to tax changes and new expenditure schemes, but direct tax changes cannot be announced. On indirect taxes, changes in customs and excise duties can be announced in a vote on account, as they only need to be notified.

On the expenditure side, the government can increase spending on existing schemes, but no budgetary allocation can be made on new schemes until the new annual financial statement is prepared after an election.

The government can provide revised estimates on revenue and expenditure for the current financial year and projections for the next financial year. However, these projections are based on certain tax buoyancy assumptions and without assuming any changes in the tax structure for next year. Therefore, if tax rates are lowered next year, which we expect will be the case and will lead to revenue losses, the interim budget is likely to underestimate the fiscal deficit. The final revised budget will only be presented after the election.

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