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Union Budget FY2012: Striving towards fiscal consolidation

In the upcoming budget, the Finance Minister might have to make tough decisions, at a time when high inflation has eroded the purchasing power of the common man

Since the last budget, the Finance Minister has successfully been able to shore the economy away from the global economic slowdown, with his strategic focus on growth bearing fruit as India emerged as one of the fastest growing economies last year. But in the upcoming budget, the Finance Minister might have to make tough decisions, at a time when high inflations has eroded the purchasing power of the common man. With elections due in West Bengal, Kerala, Tamil Nadu, Assam and Pondicherry, the government would be all the more eager to present a budget that appeals to the masses. The budget will also aim to reinstate the credibility of the government after a slew of scams and corporate governance issues have clouded India's image in the global community, hurting market sentiment.

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Expectations from the Budget 2011-12

Tax reforms

Some clarity on the roadmap for GST and DTC is expected to be provided by the Government.

Income tax exemption limit to be increased

The income tax exemption limit is likely to be increased to give more spending power to the taxpayer

To give taxpayers a relief from the high inflation, the income tax exemption limit is likely to be increased from ₹1.6 lakh per annum to bring it in line with the exemption limit of ₹2 lakh under the Direct Taxes Code (DTC). As per the DTC, which is slated to come into effect from April 2012, the Government seeks to widen tax slabs to levy 10% rate on income between ₹ 2 lakh and ₹ 5 lakh, 20% on ₹5-10 lakh and 30% above ₹10 lakh.

Reduction in duty on crude and petroleum products

A likely reduction in the duty on crude and petroleum products is on the anvil

The Finance Minister is also expected to announce a reduction in the import duty on crude (which was increased in the last budget) and the excise duty on petroleum products. This would provide considerable respite to the consumers burdened from the recent fuel price deregulation. In addition, the under-recoveries borne by the Oil Marketing Companies (OMCs) would also be reduced. In fact the IOC Chairman has recently voiced his expectations for a full rollback of duty on crude. However, this would cause a significant dent in the Government's budget calculation, with excise tax from crude and petroleum products making up more than 60% of the total excise collections.

Excise and service tax to be increased

Increase the standard rate on all non-petroleum products to 12% and service tax rate also to the pre-crisis level of 12% from the prevailing rate of 10%

In order to ensure that the lower revenue from the income tax does not adversely impact the fiscal deficit, the Government could consider the following options:

- Partially rollback the rate reduction in excise duties and increase the standard rate on all non-petroleum products to 12% and service tax rate also to the pre-crisis level of 12% from the prevailing rate of 10%.
- Trim the list of 350 items that are exempt from central excise tax.
- Increase the excise tax for sectors like FMCG, auto, cement and telecom.

The list of items exempt under the central excise duty could be trimmed

Interest subvention of 2% on export sector could be rolled back

- Items like paper products and medical equipment that are now taxed at a concessional rate might be brought back to a standard rate category.
- Service tax base to be expanded with inclusion of services such as private education, healthcare, legal services.
- Fiscal stimulus given in the last budget like the 2% interest subvention for export sector could be rolled back.
- The threshold of levy of central excise tax could be reduced from the current limit of 1.5 crore.

Expenditure on social security schemes to be increased

Social sector spending to go up

The ministry of rural development has demanded a nearly 60% increase in the allocation for the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) to around ₹64,000 crore, up from ₹41,100 crore.

Infrastructure is likely to be a beneficiary in the forthcoming Budget, with focus on power

Sector specific expectations from the budget

Infrastructure to be a key focus

Infra is likely to be an important beneficiary in the forthcoming Budget, with focus on power.

- Power:
  - The power sector may get a boost with the removal of the withholding tax on overseas investment in order to attract foreign funds.
  - Duty on import of power equipment might be reduced
- Extension of tax benefits on investments made in infrastructure bonds.
- Introduction of an infrastructure debt fund.

Withholding tax on overseas investment in the power sector could be waived off

Banking sector

Roadmap for the new bank licenses likely to be announced

Government to extend a subsidy to banks for opening 'no-frill' accounts, to encourage financial integration

- While formal guidelines for establishment of new banks in the country would be issued by the RBI however some sort of roadmap on the same could be announced in this budget. The guidelines would dwell upon issues like
  - Minimum capital for new banks and promoters contribution
  - Minimum and maximum caps on holding of promoters and others
  - Foreign shareholding
  - Business model for the new banks
  - Allocation of licenses to industrial houses, non-banking financial companies (NBFCs)
- To encourage banks to open 'no-frill' accounts, the government could extend a subsidy of ₹140 per account opened. The move will make banking accessible to many of India's currently unbanked population.

Easing of FDI norms, with FDI in single and multi brand retail likely to be increased

Retail sector

FDI in multi-brand retail likely to be announced, which will not only help in easing food inflation over the long term, but also attract foreign investment onshore. At present, FDI in multi-brand retail is prohibited, but the government allows 51% FDI in single brand retailing and 100% in wholesale trade.

Estimates for fiscal deficit and funding for FY2012

The previous section was an aggregation of various market expectations from this year's budget. What follows is our own estimations of revenue, expenditure, deficit and the quantum of market borrowing.

Fiscal deficit for FY2012 is assumed to be 4.8% of GDP

We note that the GDP base for our calculations is fairly high and is around ₹90 tn in nominal terms for the next fiscal year

(All figures are in ₹ bn)	FY 2011(BE)	FY 2012 (E)
Revenue Receipts	**6822**	**7739**
of which: Tax Revenue (net to Centre)	*5341*	*6463*
Non-tax Revenue	*1481*	*1277*
Capital Receipts	**451**	**450**
of which: Recoveries of Loans	*51*	*50*
Other Receipts	*400*	*400*
Total expenditure	**11087**	**12520**
of which: Plan expenditure	*3731*	*4402*
Non plan expenditure	*7357*	*8118*
Fiscal deficit	**3814**	**4331**
Fiscal deficit as % of GDP	**5.5**	**4.8**
Drawdown of cash balances	-	100
Market borrowing as % of deficit	88%	95%
Net borrowing	**3350**	**4019**
Gross borrowing	**4470**	**4755**

Assumptions of our calculation for FY2012: (All growth rates are over FY2011 BE)

Revenues:

Tax revenues have been fairly robust in the period till December 2010 and we expect this buoyancy to continue

- For tax revenues we have assumed a growth of 21% YoY over FY2011 BE. Currently as per CGA estimates, tax revenues FYTD till December has shown a growth rate of 27% YoY. This buoyant growth is expected to continue for the rest of the fiscal and is likely to show a spike in March on account of seasonal effects.
- For non-tax revenue, the growth rate is assumed to be around 14% YoY over last year's budgeted estimate adjusted for 3G spectrum auction.
- Revenue receipts as a whole for FYTD till December 2010, has shown a very robust growth rate of 50% YoY primarily on account of 3G and BWA gains as well as more than budgeted tax collections.
- Next fiscal year however, will not have the benefit of windfall revenues such as telecom auctions.
- We have also muted the growth rate of revenue receipts slightly on account of the fact that the Government may cut excise and customs duties on petroleum products. However, this effect may be slightly offset by robust collections on the corporate and income tax fronts. Along with this, some of the excise rollbacks that had happened during the recent crisis may be discontinued in high growth sectors such as automobiles, FMCG and cement.

We expect the budgeted expectation for disinvestment to remain at around ₹400 bn although as of now it stands at ₹230 bn and with the probable ONGC offer, it may go up to around ₹350 bn

- For non-debt capital receipts, we have assumed disinvestment proceeds to remain budgeted at ₹400 bn although this year's tally currently stands at around ₹230 bn and with the probable ONGC offer, it may go up to around ₹350 bn as against budgeted target of ₹400 bn. We continue to hold last year's assumptions for other components of non-debt capital receipts such as recoveries of loans.
- We assume total revenues adjusted for market borrowing would see some 13% YoY growth over FY2011 BE.

Expenditure:

- We have assumed plan expenditure to grow at around 18% YoY and non-plan, which constitutes the more significant chunk of spending to grow at around 10% YoY.
- The high growth rate assumed for plan expenditure is on account of the fact that FY2012 is the last year for the 11th Plan period and this typically sees a spurt in expenditure.

We expect subsidies to remain a significant chunk of total spending and food, fertilizer, fuel and irrigation may comprise a substantial amount of expenditure

Subsidies:

- We have assumed food and fertilizer subsidies to remain at around ₹550 bn and ₹500 bn respectively. However, we believe that the Government will budget for a higher cash subsidy for fuel as against the minimal amount accounted for in the last budget. As per latest estimates, the subsidy to be provided by the Government stands at around ₹500 bn, which we have incorporated in our calculations. Subsidies may trend higher on account of more allocation to fertilizer and irrigation.
- Since schemes such as MGNREGS are now linked to inflation indices and the Government's continued focus on social and rural welfare projects with special emphasis on infrastructure will lead to a higher expenditure trajectory.
- Overall we assume expenditure to stand at around ₹1252 bn as against ₹1108 bn (not adjusted for supplementary grants).

Fiscal deficit:

Fiscal deficit in absolute terms may actually go up to around ₹4330 bn with a nominal GDP growth of around 14% YoY

- Our fiscal deficit in absolute terms stands at around ₹4330 bn, which is approximately 4.8% of GDP. For our GDP assumptions, we have assumed a nominal growth rate of 14% YoY on the Government of India's Advance Estimate for FY2011 of around ₹78780 bn.
- We also assume that the Government will carry cash surplus to the tune of ₹100 bn and 95% of the remaining deficit is likely to be met through market borrowing.

Net borrowing estimate (with an assumption of 95% of deficit to be met through market loans) stands at ₹4019 bn

- Hence our net borrowing estimate is ₹4019 bn. Given that redemptions are around ₹735 bn, gross borrowing stands at around ₹4755 bn.
- We assume FY2011 fiscal deficit as % of GDP to be around 5.2-5.3%.

Market impact

Upward pressure on yields is expected to remain on the back of increased bond supply and elevated inflation

Fixed income: The amount of borrowing in absolute terms is higher this year as compared to last despite fiscal deficit as % of GDP being lower. This is partly attributable to higher GDP base as well. Since most of our borrowing program is front loaded, the first half of FY2012 will witness strong upward pressures on yields. Coupled with this, we expect inflation numbers to also remain elevated. Given this scenario, it is likely that the benchmark yields will trade in the range of 8.30-8.50% over the better part of the next fiscal year.

Further clarity on FDI norms and steps taken towards this end will favour capital flows, which will benefit Rupee over the long term

Forex: There is likely to be a clear focus towards attracting foreign funds in order to accelerate investment in key sectors like infrastructure. With FDI in single-brand and multi-brand retail also likely to increase, we expect capital inflows to stay buoyant this fiscal. This would be favorable for the Rupee over the medium to long term. However, the possible reduction in incentives given to exporters and removal of the tax holiday for IT companies could pose a risk to our medium term Rupee appreciation view.

Annexure I

Estimates of the Economic Advisory Council

- The Economic Advisory Council (EAC) in its Review of the Economy 2010-11 retained its growth forecast for FY2012 at 9% YoY (same as that estimated in the Economic Outlook published in July). However, the composition of growth has changed. The forecast for industrial growth has been revised down to 9.2% YoY from 10.3% YoY in the July report while that of services has been revised up to 10.3% YoY from 9.6% YoY earlier. The Council estimates FY2011 growth to be around 8.6% YoY.
- The Council has increased its inflation forecast by 50 bps to 7% YoY for end FY2011.
- EAC expects Current Account Deficit to GDP ratio to be around 3.0% in FY 2011 and reduce to around 2.8% in FY2012.
- The fiscal deficit as a ratio of GDP is estimated to be 5.2% in FY2011 and the consolidated fiscal deficit of Central and State governments is estimated at 8%.
- The Council also said "the pace of infrastructure creation has to be stepped up". The report especially highlights the shortfall in the capacity additions in the power sector, with the deficit largely originating from the public sector.

Annexure II

Revenue receipts consists of tax revenues and other revenues. Tax revenues consist of proceeds from tax and duties levied. Other receipts are made up of interest and dividend payment and receipts for services rendered by the Government.

Revenue expenditure consists of wages and salaries, interest payments, subsidies and normal functioning of various ministries. This can more or less be classified as expenditure, which does not result in asset creation for Government of India.

Capital receipts consist of loans raised by the Government from the public, otherwise know as market borrowing, borrowing from the RBI, loans from foreign governments and other multilateral bodies and recoveries of loans. Recently, disinvestment by the Government has also started to contribute significantly to capital receipts.

Capital expenditure mainly consists of acquisitions such as land, machinery, equipment and investments in various financial instruments.

Government expenditure is classified under two heads viz. plan and non-plan.
Plan expenditure arises out of schemes freshly introduced in an ongoing Five-Year Plan (FYP) period. In the same period, non-plan expenditure arises out of schemes carried forward from previous FYP periods.
Non-Plan expenditure, therefore, supports the old schemes of governments and plan expenditure, the new schemes. Since new schemes add to the economy's productive capacity as the old schemes did in the past, plan expenditure reflects government's investment in enhancing the economy's productive capacity. Thus non-plan expenditure maintains the existing capacities and plan expenditure adds to it.

Fiscal deficit is defined as total expenditure less revenue receipts, recoveries of loans and other receipts. Total expenditure is the sum of plan and non-plan expenditure.

Primary deficit is defined as fiscal deficit net of interest payments.

(Source: Budget documents and Planning Commission)

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