

## 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***

***With elections due in West Bengal, Kerala, Tamil Nadu, Assam and Pondicherry, the government would be eager to present a budget that appeals to the masses***

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

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

***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%***

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

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 inflation 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.

### 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

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

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

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.

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

***Expenditure on social security schemes to be increased***

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

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

***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***

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

- 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.

### **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.

### **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.

#### **Banking sector**

- 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.

#### **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**

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

**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**

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

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

#### Revenues:

- 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.
- 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.

<p><b><i>We expect subsidies to remain a significant chunk of total spending and food, fertilizer, fuel and irrigation may comprise a substantial amount of expenditure</i></b></p> <p><b><i>Fiscal deficit in absolute terms may actually go up to around ₹4330 bn with a nominal GDP growth of around 14% YoY</i></b></p> <p><b><i>Net borrowing estimate (with an assumption of 95% of deficit to be met through market loans) stands at ₹4019 bn</i></b></p> <p><b><i>Upward pressure on yields is expected to remain on the back of increased bond supply and elevated inflation</i></b></p> <p><b><i>Further clarity on FDI norms and steps taken towards this end will favour capital flows, which will benefit Rupee over the long term</i></b></p>	<p><b>Expenditure:</b></p> <ul style="list-style-type: none"> <li>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.</li> <li>The high growth rate assumed for plan expenditure is on account of the fact that FY2012 is the last year for the 11<sup>th</sup> Plan period and this typically sees a spurt in expenditure.</li> </ul> <p><b>Subsidies:</b></p> <ul style="list-style-type: none"> <li>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.</li> <li>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.</li> <li>Overall we assume expenditure to stand at around ₹1252 bn as against ₹1108 bn (not adjusted for supplementary grants).</li> </ul> <p><b>Fiscal deficit:</b></p> <ul style="list-style-type: none"> <li>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.</li> <li>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.</li> <li>Hence our net borrowing estimate is ₹4019 bn. Given that redemptions are around ₹735 bn, gross borrowing stands at around ₹4755 bn.</li> <li>We assume FY2011 fiscal deficit as % of GDP to be around 5.2-5.3%.</li> </ul> <p><b>Market impact</b></p> <p><b>Fixed income:</b> 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.</p> <p><b>Forex:</b> 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.</p>
---	---

---

## 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 known 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)*



Treasury Research Group			
Economics Research			
Ruchi Singh	Economist	(+91-22) 2653-6280	ruchi.singh@icicibank.com
Surbhi Ogra	Economist	(+91-22) 2653-7243	surbhi.ogra@icicibank.com
Upasna Bhardwaj	Economist	(+91-22) 2653-7233	upasna.bhardwaj@icicibank.com
Kamalika Das	Economist	(+91-22) 2653-1414 (ext 2027)	kamalika.das@icicibank.com
Kanika Pasricha	Economist	(+91-22) 2653-1414 (ext 2260)	kanika.pasricha@icicibank.com
Samir Tripathi	Economist	(+91-22) 2653-1414 (ext 2023)	samir.tripathi@icicibank.com
Sumedh Deorukhkar	Economist	(+91-22) 2653-1414 (ext 2085)	sumedh.deorukhkar@icicibank.com
Abhishek Upadhyay	Economist	(+91-22) 2653-1414 (ext 2195)	abhishek.u@icicibank.com
Rahul Agarwal	Economist	(+91-22) 2653-1414 (ext 2291)	agarwal.rah@icicibank.com
Tadit Kundu	Economist	(+91-22) 2653-1414 (ext 2087)	tadit.kundu@icicibank.com

Treasury Desks			
Treasury Sales	(+91-22) 2653-1076-80	Currency Desk	(+91-22) 2652-3228-33
Gsec Desk	(+91-22) 2653-1001-05	FX Derivatives	(+91-22) 2653-8941/43
Interest Rate Derivatives	(+91-22) 2653-1011-15	Commodities Desk	(+91-22) 2653-1037-42
Corporate Bonds	(+91-22) 2653-7242		

#### Disclaimer

Any information in this email should not be construed as an offer, invitation, solicitation, solution or advice of any kind to buy or sell any financial products or services offered by ICICI Bank, unless specifically stated so. ICICI Bank is not acting as your financial adviser or in a fiduciary capacity in respect of this proposed transaction with you unless otherwise expressly agreed by us in writing. Before entering into any transaction you should take steps to ensure that you understand the transaction and have made an independent assessment of the appropriateness of the transaction in the light of your own objectives and circumstances, including the possible risks and benefits of entering into such transaction. You may consider asking advice from your advisers in making this assessment.

#### Disclaimer for US/UK/Belgium residents

This document is issued solely by ICICI Bank Limited ("ICICI"). The material in this document is derived from sources ICICI believes to be reliable but which have not been independently verified. In preparing this document, ICICI has relied upon and assumed, the accuracy and completeness of all information available from public sources. ICICI makes no guarantee of the accuracy and completeness of factual or analytical data and is not responsible for errors of transmission or reception. The opinions contained in such material constitute the judgment of ICICI in relation to the matters which are the subject of such material as at the date of its publication, all of which are expressed without any responsibility on ICICI's part and are subject to change without notice. ICICI has no duty to update this document, the opinions, factual or analytical data contained herein. The information and opinions in such material are given by ICICI as part of its internal research activity and not as manager of or adviser in relation to any assets or investments and no consideration has been given to the particular needs of any recipient.

Except for the historical information contained herein, statements in this document, which contain words or phrases such as 'will', 'would', etc., and similar expressions or variations of such expressions may constitute 'forward-looking statements'. These forward-looking statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially from those suggested by the forward-looking statements. ICICI Bank undertakes no obligation to update forward-looking statements to reflect events or circumstances after the date thereof. Nothing contained in this publication shall constitute or be deemed to constitute an offer to sell/purchase or as an invitation or solicitation to do so for any securities or financial products of any entity. ICICI Bank and/or its Affiliates, ("ICICI Group") make no representation as to the accuracy, completeness or reliability of any information contained herein or otherwise provided and hereby disclaim any liability with regard to the same. ICICI Group or its officers, employees, personnel, directors may be associated in a commercial or personal capacity or may have a commercial interest including as proprietary traders in or with the securities and/or companies or issues or matters as contained in this publication and such commercial capacity or interest whether or not differing with or conflicting with this publication, shall not make or render ICICI Group liable in any manner whatsoever & ICICI Group or any of its officers, employees, personnel, directors shall not be liable for any loss, damage, liability whatsoever for any direct or indirect loss arising from the use or access of any information that may be displayed in this publication from time to time. This document is intended for distribution solely to customers of ICICI. No part of this report may be copied or redistributed by any recipient for any purpose without ICICI's prior written consent. If the reader of this message is not the intended recipient and has received this transmission in error, please immediately notify ICICI, Akhil Salgia, E-mail: [akhil.salgia@icicibank.com](mailto:akhil.salgia@icicibank.com) or by telephone at +1 646-827-8459 and please delete this message from your system.