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India union budget preview: Government borrowing could remain high

- India will present its annual Union Budget on February 28. Market participants will be keenly watching the government's fiscal deficit numbers, and any significant reforms.
- We expect the central fiscal deficit for FY11 to come in at 4.9% of GDP largely due to the windfall on 3G telecom auctions and privatization proceeds. For FY12, even with revenue measures and slower growth in expenditures, we expect the central deficit to be slightly higher at 5.0% of GDP, largely as the one-off revenues would be considerably reduced.
- In our view, the overall fiscal consolidation could impart a negative fiscal impulse after 3 years of positive impulse. We think the risks to the deficit target are skewed to the upside due to continued spending pressures on food and fuel subsidies.
- We believe the government could announce market borrowings of around Rs3.8 trillion (US$80 billion), which would be significantly higher than the borrowings in FY11, and we think on balance, this could be negative for government bonds.
- In terms of specific measures, on the taxation side, we expect some broad basing of the service tax, higher income tax exemptions, and a possible increase in excise duties on autos. On the expenditure side, we expect the budget to have increases in food subsidies and National Rural Employment Guarantee Act, along with a continued increase in outlays on infrastructure.
- Our sector analysts think the budget will be positive for the infrastructure and utilities sectors, and negative for iron-ore exporters and tobacco companies.

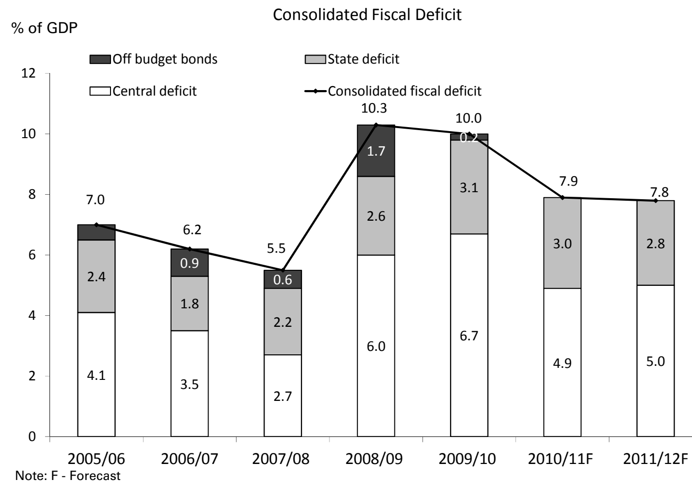
The FY12 Union Budget comes at a critical juncture for the economy—high inflation, tight liquidity, elevated fiscal and current account deficits, and a slowdown in the reform process have taken away the sheen from the India growth story. Potentially, the budget provides an opportunity to move towards fiscal consolidation and to make a bold statement on reform. However, there are strong reasons which could prevent such a move—state elections in 5 states over the summer, elevated inflationary pressures, and governance issues. Moreover, this is a mid-term budget, and with key tax reforms such as the GST and direct tax code a year away, we do not think there will be many surprises in the budget.

Fiscal consolidation sans 3G?

The primary focus of the budget remains how much the government can reduce its market borrowing. In 2010-2011, the deficit was buoyed by one-off items—the much-larger–than-expected 3G and BWA telecom auctions (Rs1060 billion), privatization (Rs227 billion), and higher nominal GDP growth. Including these, we believe the central deficit could end at 4.9% of GDP, much lower than the budgeted figure of 5.5% of GDP. However, if we exclude the one-off items from telecom and privatization, then the deficit could rise to 6.7% of GDP.

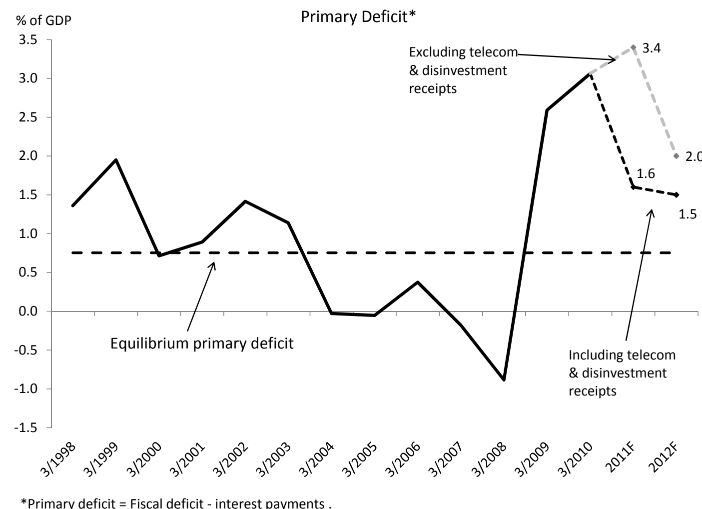
For FY12, we expect the fiscal deficit to remain at 5.0% of GDP including privatization and additional telecom receipts. Without these, however, the deficit could come in higher at 5.5% of GDP. Yet, this can constitute some fiscal consolidation through higher revenues and current expenditures growing slower than nominal GDP.

Exhibit 1: Fiscal deficit is likely to remain high in FY12



Source: CEIC, GS Global ECS Research estimates.

Exhibit 2: Primary deficit (fiscal deficit minus interest payments) remains higher than historical average



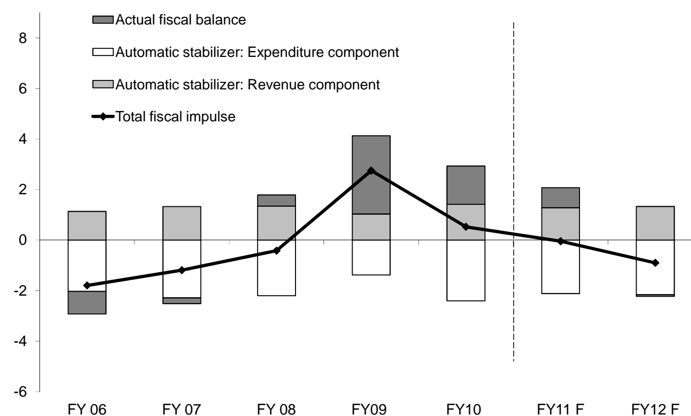
Source: CEIC, GS Global ECS Research estimates.

Exhibit 3: The fiscal numbers—the difficult arithmetic of consolidation

Central fiscal deficit	FY09	FY10	FY11 (BE)*	FY11 (GS)	FY12 (GS)
Rs bn					
Revenue receipts	**5469**	**6062**	**6822**	**7762**	**8505**
%yoy		*10.8*	*12.5*	*28.0*	*9.6*
Net tax revenue	4433	4651	5341	5453	6834
Non tax revenue (ex telecom receipts)	969	1122	1131	1149	1571
Telecom receipts		0	350	1160	100
Non-debt capital receipts (excluding disinvestment)	**61**	**43**	**51**	**108**	**100**
Disinvestments	**6**	**260**	**400**	**350**	**350**
Total expenditure	**8840**	**10215**	**11087**	**11798**	**13277**
% yoy		*15.6*	*8.5*	*15.5*	*12.5*
Current expenditure	7938	9064	9587	10334	11577
%yoy		*14.2*	*5.8*	*14.0*	*12.0*
Subsidies	*1194*	1236	1115	1538	*1883*
Food	*436*	*560*	*556*	*680*	*720*
Fertilizers	*758*	*530*	*528*	*628*	*700*
Petroleum	-	*146*	*31*	*230*	*463*
NREGA	*160*	*391*	*401*	-	*640*
Capital expenditure	902	1105	1500	1464	1700
%yoy		*22.6*	*35.8*	*32.5*	*13.3*
Fiscal deficit (excl. disinvestment & telecom)	3369	4153	4615	5096	4872
Fiscal deficit (incl. disinvestment & 3G)	3363	3845	3814	3686	4422
% of GDP	**FY09**	**FY10**	**FY11 (BE)**	**FY11 (GS)**	**FY12 (GS)**
Revenue receipts	9.8	9.7	9.0	10.2	9.6
Total expenditure	15.9	16.4	14.7	15.5	15.0
Current expenditure	14.2	14.5	12.7	13.7	13.1
Capital expenditure	1.6	1.8	2.0	1.9	1.9
Fiscal deficit (excl. disinvestment & telecom)	**6.0**	**6.7**	**6.1**	**6.7**	**5.5**
Fiscal deficit (incl. disinvestment & telecom)	**6.0**	**6.2**	**5.5**	**4.9**	**5.0**
Disinvestment	6	320	400	350	350
Telecom receipts (2G & 3G)	0	47	140	1060	100
Net market loans	2620	3756	3450	3297	3772
Repayments	826	952	1373	1373	900
Gross market loans	**3446**	**4708**	**4823**	**4670**	**4672**

Note: BE = Budget Estimates.
Source: CEIC, GS Global ECS Research estimates.

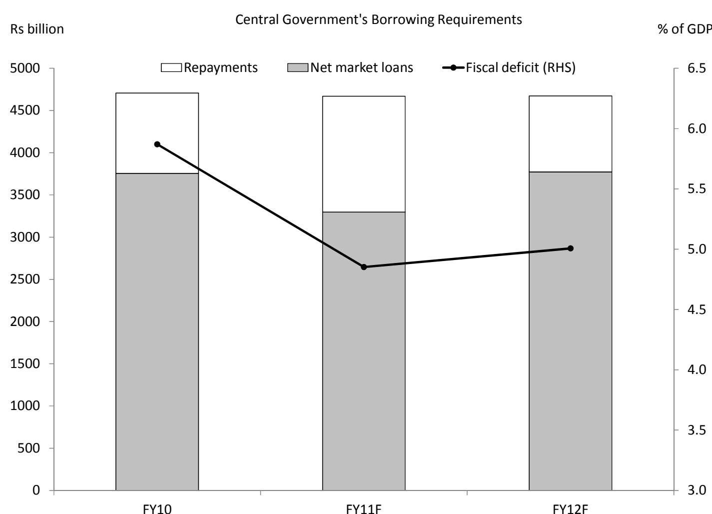
Exhibit 4: Stimulus is gradually waning



Source: CEIC, GS Global ECS Research estimates.

Our fiscal impulse[1] estimates, which measures how much stimulus fiscal policy is providing to the economy suggest that the government impulse could be negative for FY12, if there is indeed the fiscal consolidation that we expect in the budget. In FY11, the fiscal impulse was essentially zero excluding the telecom and disinvestment proceeds.

Exhibit 5: We expect government borrowing to remain too high for comfort



Source: CEIC, GS Global ECS Research estimates.

In terms of market borrowing, we think the government's net market borrowing could be higher at Rs3.8 trillion (US$80 billion), compared to a projected Rs3.45 trillion (US$76 billion) in FY11, as the one-off telecom receipts are not available in FY12. We think the larger borrowing requirement at a time when liquidity remains very tight (see *India: Risks at the start of 2011*, Asia Economics Flash, January 13, 2011), could be negative for government bonds.

Tax proposals

The budget may contain the following tax changes which would overall be revenue positive:

- Income tax relief can be provided to lower income brackets to compensate for inflation. This could take the form of raising the tax exemption limit from the current 1.6 lakh (US$3,500).
- Excise duty on automobiles could be raised to 12% from 10%, rolling back the stimulus given during the financial crisis.
- The tax base for the service tax will likely be expanded by including health and education services within its ambit.
- Export duties on iron ore may be increased, as could excise taxes on tobacco companies.

[1] Fiscal impulse: $FI = -\Delta B - G0\Delta Yp + T0\Delta Y$.

Where: FI = absolute measure of the fiscal impulse, T = central government revenues, G = central government expenditures, ΔB = the actual budget balance (B = T-G), G0 = expenditure ratio (rolling average), T0 = revenue ratio (rolling average), ΔYp = change in potential output, ΔY = change in nominal output.

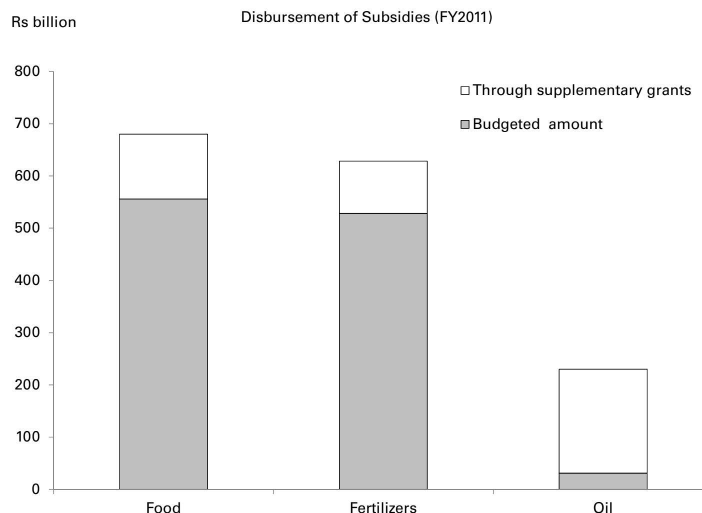
The measure of FI attempts to remove transitory changes (by adjusting for the effects of automatic stabilizers) in the actual budget balance. Hence a positive FI implies a more expansionary fiscal stance compared to the previous year and vice versa.

- Incentives for greater foreign investment in corporate bonds by reducing the withholding tax on interest income to 10% from 20%.

Expenditure proposals

- The National Rural Employment Guarantee Act (NREGA) could see a substantial increase in outlay. We estimate budget FY12 could make a provision of Rs640 billion for the NREGA in 2011-2012, against Rs401 billion in the current fiscal year.
- Food subsidy bill may be increased, especially given the higher food prices.
- The government has planned to free urea prices under the Nutrient-based Subsidy (NBS) policy regime, and as a result, could raise urea prices in the budget. This would help reduce fertilizer subsidies.

Exhibit 6: Rising fertilizer and oil prices increased the subsidy bill in FY11 and can continue to put pressure on subsidies in FY12



Source: CEIC, GS Global ECS Research estimates.

Reforms

Market participants are looking for reforms in the areas of FDI in retail, a firm date for the GST, speedier resolution of land acquisition issues, and reducing fertilizer subsidies. Any developments on these fronts could be seen as a positive.

However, given the challenges in front of the government, we do not envisage a major reform push in the budget.

Exhibit 7: Our analysts' sector-wise expectations from the budget

Sector (Analyst name)	Key expectations from budget	Probability/Impact
Cement *(Pritesh Vinay)*	Expect no change in excise duty - currently at 10%.	High/Neutral
Metals & Mining *(Pritesh Vinay)*	Potential hike in export duty of iron ore (currently at 5% for fines and 15% for lumps).	High/Negative for ore exporters
	Rise in import duty on Hot Rolled Coils (steel) from prevalent 5% to 10%.	Low/Positive for domestic steel producers
IT *(Balaji Prasad)*	Extension of STPI Tax holidays till Mar 12, when DTC could be implemented. The end of STPI holidays was announced more than a year and a half ago, and has been priced in by the market.	Low/Low
Pharma *(Balaji Prasad)*	Infrastructure status for health-care industry, greater outlay for health-care services in semi-urban and rural areas.	Low/Low-Moderate
	Rise in weighted average exemption on R&D from 150% to 200%.	Low/Low
	Customs duty exemption for Medical devices & life saving drugs.	Low/Low
Telcos *(Sachin Salgaonkar)*	The govt may look to generate around Rs 17,000 cr (amount recommended by TRAI) from the excess 2G spectrum which incumbent operators have.	Medium/Neutral
	Potential decline in license fees as recommended by TRAI.	Low/Neutral
Consumer Goods *(Puneet Jain)*	High single-digit increase in cigarette excise taxes. Hike of 6%-7% could be recovered by companies, beyond that may negatively impact volumes.	High/Negative
	We expect some clarity on goods and services tax which could be introduced over the next twelve months.	
Real Estate *(Puneet Jain)*	Incentives for affordable housing such as a) an increase in the limit for income tax deduction on interest on home loans, which is currently Rs150,000 and/or b) an increase in the limit for income tax deduction on interest on home loan principal payments, which is currently Rs100,000.	Low/Positive
Utilities *(Durga Dath)*	Withdrawal of withholding tax would help players raise foreign debt at less expensive rates.	High/Moderate
	Continued support to UMPPs' execution.	Moderate
	Financial relief for SEBs in the form of new schemes in power distribution.	Moderate
	Continued Tax sops for setting up power projects based on renewable energy.	Moderate
	Assistance to raise low-cost and long-term resources to re-finance power projects.	Moderate
Fertilizers *(Durga Dath)*	Inclusion of Urea in NBS Scheme, price decontrol. Increased subsidy budgets.	Moderate
Automobiles *(Sandeep Pandya)*	Possible reversal of stimulus by increasing excise duty on cars & 2-wheelers by 2 percentage points, which will be immediately passed on to consumers in our view. On a cyclical basis, we believe this could present challenges to demand growth and pricing power of companies going into FY2012E.	Low/Negative
Banks *(Tabassum Inamdar)*	Indirect implication from fiscal deficit, i.e. higher or lower than market expectation.	Positive/Negative impact depending on lower/higher than expected deficit
	Possible details of capital infusion for banks.	Positive for banks due to receive capital
Capital Goods *(Ishan Sethi)*	Levy of duty on imported power equipment - supporting domestic manufacturing.	Moderate/ Slightly positive
Infrastructure *(Ishan Sethi)*	Incremental allocation to infrastructure sectors - roads, rail etc - especially focused on social spending through schemes such as Bharat Nirman, JNNURM, RGGVY.	High/Positive
	MAT break for Infra projects for the initial period of income tax holiday.	Moderate/Positive
	Single window clearance system for road and power projects - possibly on the lines of single agency alearance/Land bank corporations.	Moderate/ Very Positive
	Facility to streamline debt market for infrastructure - possibly through seeding the planned $11bn Infra debt fund.	Moderate/ Very Positive
Logistics *(Ishan Sethi)*	Clarity on the timeline and implementation of GST.	High/ Positive
	Concrete steps to expedite work on the Dedicated Freight corridors.	Moderate/ Positive
	Incentives for cold-chain logistics network, both transportation and warehousing.	High/ Positive
Media *(Ishan Sethi)*	Cut in DTH license fee from 10% to 6%.	Moderate/ Positive
	Removal of basic customs duty on imported set-top-boxes(5% now).	Moderate/ Positive

Source: CEIC, GS Global Investment Research and GS Global ECS Research estimates.

We, Tushar Poddar and Vishal Vaibhaw, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.

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