

Asia Economics Flash

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India's consolidation budget

- The 2007-2008 budget consolidates recent gains in revenue overperformance, without any major reforms or changes in the tax structure.
- The focus is on increased expenditure in social sectors, infrastructure, and agriculture, to consolidate the growth momentum.
- The fiscal deficit to decline in line with fiscal responsibility targets, however, in our view, not by enough to make yields fall.
- Near-term inflation unlikely to be significantly affected as our fiscal impulse estimates remains unchanged. We expect further monetary tightening going forward.
- We believe tax proposals would negatively affect construction, IT, and cement and positively affect telecoms and healthcare.

The 2007-2008¹ budget presented by the finance minister on February 28 seeks to consolidate the recent gains in tax revenues and growth, without any major reforms or changes to the tax system. As expected, given that it's a mid-term budget with an eye on the general elections in 2009, the budget offers significant increases in infrastructure, agriculture, and social spending.

Although India's spending on social sectors and infrastructure is low, we would have liked to see the government concentrate on service delivery and better targeting of spending while using increased tax receipts to reduce debt. While we find the proposed reduction in the revenue deficit by 0.5% of GDP creditable, the finance minister has preferred to play it politically safe by spending more and not saving the revenue over-performance, as well as not pushing for contentious reforms in labor, pension, the financial sector, insurance, and privatization.

The budget envisages about a 21% increase in both revenues and expenditures, and a change in the composition of spending to capital expenditures, which increase by a whopping 70%. The shift away from current expenditures, especially the decline in subsidies, is welcome. Within the tax categories, nearly all the components, with the exception of excise are slated for about a 20% increase, which seems eminently achievable given the current growth momentum in the economy. Thus, in terms of the overall picture, the big change is the increase in capital and social spending.

**Goldman
Sachs**

¹ FY2007 refers to fiscal year 2006-2007, i.e., April to March. FY2008 refers to fiscal year 2007-2008.

Exhibit 1: Much needed infrastructure and social spending are a positive for growth

% of GDP	India		China
	2006/07e	2007/08 budget	2006e
Total tax revenue	11.4	12.1	16.6
Of which: corporate tax	3.6	3.7	
income tax	2.0	2.2	
excise taxes	2.9	2.9	
custom duties	2.0	2.2	
Total expenditure	14.2	15.0	19.5
Current expenditure			
Of which: interest payments	3.6	3.5	0.5
subsidies	1.3	1.2	0.7
Capital expenditure	1.8	2.7	3.9
Capital expenditure excl defence	1.0	1.8	
Memo items:			
Social spending	1.4	1.8	3.9
Agriculture	1.8	1.9	#N/A
US\$ bn			
Total revenue	102.8	124.7	21.3
Of which: corporate tax	32.2	38.3	19.1
income tax	18.1	22.5	24.0
excise taxes	25.8	29.6	15.0
custom duties	18.0	22.5	25.1
Total expenditure	127.8	154.9	21.2
Current expenditure			
Of which: interest payments	32.1	36.2	12.6
subsidies	11.8	12.4	5.1
Capital expenditure	16.4	27.9	69.8
Capital expenditure excl defence	8.9	18.4	107.4
Memo items:			
Social spending	13.0	18.3	40.7
Agriculture	16.2	19.5	20.0

Source: Ministry of Finance, IMF, CEIC, Goldman Sachs Economics Research.

How will the budget affect inflation?

We do not expect the budget to significantly contain inflationary pressures in the near term in the economy. Although the fiscal deficit is budgeted to decline to 3.3% of GDP from 3.7% in FY2008 (see Exhibit 2), the fiscal impulse² remains unchanged according to our estimates. The fiscal impulse is a very useful measure to assess how expansionary (contractionary) fiscal policy is compared to the previous year. Exhibit 3 shows that fiscal policy has been mildly contractionary in FY2007 and will remain so in FY2008 according to the budget. Given that inflation has trended up in the last 6 months of FY2007, even with the negative impulse, suggesting that further contraction would be necessary going forward. There is, however, no additional decline in the impulse envisaged in the budget to contain inflationary pressures due to the higher expenditures.

² Fiscal impulse: $FI = -\Delta B - G0\Delta Y_p + T0\Delta Y$

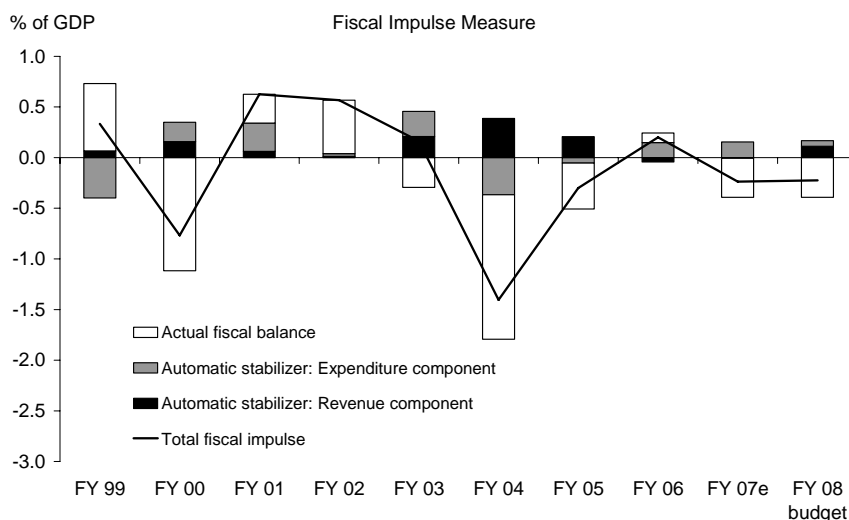
Where: FI = absolute measure of the fiscal impulse, T = central government revenues, G = central government expenditures, ΔB = the actual budget balance ($B = T - G$), $G0$ = expenditure ratio (rolling average), $T0$ = revenue ratio (rolling average), ΔY_p = change in potential output, ΔY = change in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

Exhibit 2: Further declines in deficit

(% of GDP)	Central government	
	Gross fiscal deficit	Revenue deficit
1997/98	5.8	3.0
1998/99	6.5	3.8
1999/00	5.4	3.5
2000/01	5.7	4.1
2001/02	6.2	4.4
2002/03	5.8	4.3
2003/04	4.4	3.6
2004/05	4.0	2.5
2005/06	4.1	2.6
2006/07 (budget)	3.8	2.1
2006/07 (revised)	3.7	2.0
2007/08 (budget)	3.3	1.5

Source: Ministry of Finance, CEIC, Goldman Sachs Economics Research.

Exhibit 3: The budgeted fiscal stance is only mildly disinflationary

Source: Ministry of Finance, CEIC, Goldman Sachs Economics Research.

To curb prices, the government announced a cut in the peak customs duty to 10% from 12.5% which will result in some reduction in import prices, as well as increasing competition to restrain the pricing power of producers. The emphasis on infrastructure, agriculture and social spending in the budget seeks to address long-term growth potential in the economy rather than short-term inflationary pressures. Thus, given that more aggressive contractionary fiscal policy is not forthcoming, we expect further monetary tightening going forward to reduce aggregate demand. In particular, we expect a further 25 bp increase in policy rates in April, and the risks of even further tightening have increased.

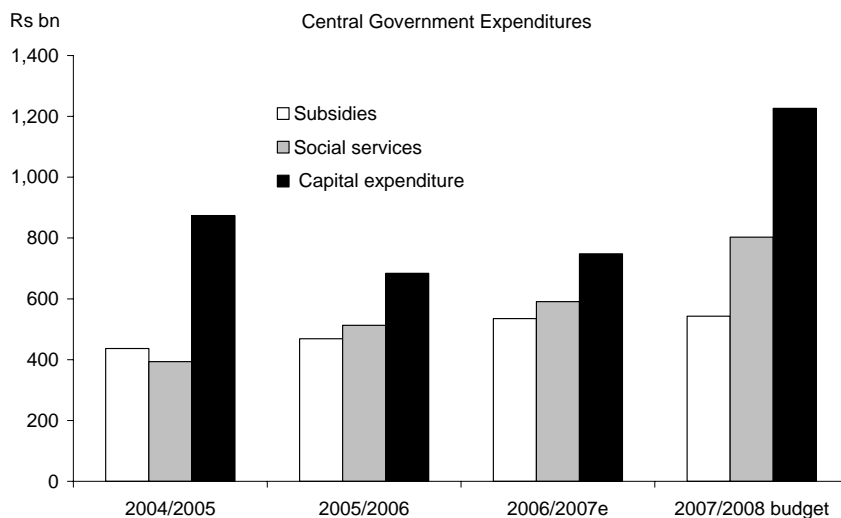
How will the budget affect growth?

Our growth projections for FY2008 are unchanged at 8%. We see the budget as long-term growth enabling due to the emphasis on infrastructure, agriculture, and education spending. Non-defense capital expenditure is slated to increase by nearly 70% to 1.8% of GDP from 1% of GDP.

We welcome the increase in social spending, in sectors such as health, and education, in particular, with provisions for secondary education nearly doubling, as we anticipated. Proposals to increase skills training and employment generation are also welcome as these increases will be a positive for growth. The change in the composition of spending is also beneficial, as subsidies have been reduced and social services and capital expenditures have been increased.

Capital expenditures and social spending, both in absolute terms and in % of GDP in India are much lower than other Asian countries. Indeed, India will spend about US\$18 billion on social sectors in FY2008, compared to US\$105 billion spent by China in 2006. Similarly, India will spend about US\$28 billion in capital expenditure compared to US\$106 billion by China.

Exhibit 4: A welcomed shift in the composition of spending



Source: CEIC, Goldman Sachs Economics Research.

We would emphasize that the government needs to focus on the execution and delivery of its various schemes before putting in additional resources. Indeed, a significant portion of the yearly budgets for its flagship programs such as the SSA universal primary education program and the urban renewal program (JURM) remain unspent. It is important to create adequate capacity to implement and better target current programs rather than increase resources considerably.

How will the budget affect bond yields?

The gradual reduction in the fiscal deficit will reduce borrowing requirements and put downward pressure on bond yields. However, given that interest rates are rising, and that the deficit reduction is not as aggressive as we had envisaged, yields are likely to increase marginally. We expect the 10-year government bond yield to be at about 8% on average in FY2008.

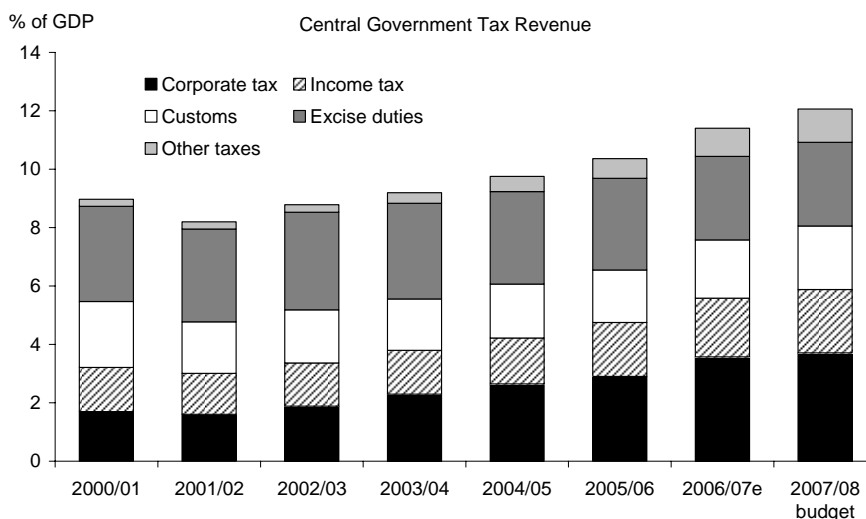
What are the key tax proposals and how will it affect sectors?

Some of the more important tax proposals in the budget are:

- A reduction in the peak customs duty for non-agricultural products to 10% from 12.5%.
- Increase in the dividend distribution tax to 15% from 12.5%.
- Increase in the education cess on corporate tax by 1% which increases the effective corporate tax to about 34% from 33.33%.
- Reduction in the excise duty on petroleum products from 6% to 8%.
- Increase in the excise duty to Rs.600 from Rs.400 per metric ton on cement sold above Rs.190 a bag.
- Extension of the service tax to rentals paid on commercial property.
- The removal of tax holidays for construction companies, thus making them liable for income tax, retrospectively from FY2000.

- The removal of a surcharge for companies with profits less than 1 crore, likely to reduce corporate tax by about 3%.
- An application of the Minimum Alternative Tax (MAT) to IT companies – effectively a tax of about 11.33%.

Exhibit 5: Corporate and income tax collections continue to rise



Source: CEIC, Goldman Sachs Economics Research.

For the banking sector, the impact is likely to be mildly positive due to equalization of taxation between income from deposits and money market mutual funds eliminating arbitrage.

For the healthcare sector, the impact is mildly positive due to increased healthcare spending by the government, the exemption from service tax for clinical trials, and incentives given for encouraging R&D investments.

For the cement sector, the budget is negative due to the increase in excise duties for cement companies, nearly all of which exceed the stipulated retail threshold price. Iron-ore exports become dearer with the institution of an export duty.

For the telecom sector, the budget was positive. Indian telecom service providers would benefit from the reduction in peak import tariffs on equipment and a continuation of lower tariffs on mobile handsets, thereby lowering capital expenditures and increasing affordability.

For the power sector, the reduction in peak import tariffs on equipment would potentially lower the cost of setting up a generation or transmission facility, in turn, reducing the cost of electricity.

For downstream oil companies, the excise duty cut on petroleum and diesel would be marginally positive. Import tariff cuts for petrochemicals, however, were widely anticipated and hence no significant negative surprise to the expectations from the above measure. Extension of tax incentives to gas distribution companies would be positive.

For the IT sector, the budget is likely to be negative. Two factors are likely to drag on the net profitability of IT services companies: 1) the extension of the MAT is expected to increase tax rates by 11.3%, impacting export revenues from software technology parks currently under a tax holiday; 2) the fringe benefit tax on employee stock ownership plans (ESOPs).

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