ECONOMIC RESEARCH

IDBI capital

Budget 2007-08 – An Analysis

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Highlights of the Budget

- For 2007-08, Revenue Deficit estimated at 1.5% and Fiscal Deficit at 3.3% of GDP
- Budgeted Gross Borrowing Program for 2007-08 set at Rs 181,455 cr, 8.4% higher than Rs 173,000 cr
- Annual ceiling for Market Stabilization Scheme increased to Rs 80,000 cr from Rs 70,000 cr
- Ways and means advances expected to quadruple in 2007-08 to Rs 100,000 cr from revised estimate of Rs 25,226 cr in 2006-07
- Slippage in Fiscal Deficit target for 2006-07 due to rise in Non-Plan Expenditure
- Usage of "small part" of foreign exchange reserves proposed for financing domestic infrastructure projects
- Autonomous Debt Management Office proposed to be set up
- Government proposes to acquire RBI's equity holding in State Bank of India and a sum of Rs 40,000 cr provided for the same
- Agriculture to receive a boost through development programs, subsidies, credit aid etc.
- Allocations to education and health & family welfare to increase by 34.2% and 21.9% respectively
- Excise and customs duty cuts announced for selected sectors
- Service tax net extended to cover more services
- The threshold limit of exemption in the case of all assessees be increased by Rs.10,000, thus giving every assessee a relief of Rs.1,000
- Corporate income tax rate remains unchanged however; surcharge on income tax to be removed for firms and companies with taxable income of less than Rs 1 crore
- Allocation for Defence expenditure to increase to Rs 96,000 cr
- Allocation for e-governance to be increased to Rs 719 cr in 2007-08 from Rs 395 cr in 2006-07
- National Housing Board to introduce a novel product, a reverse mortgage, for senior citizens

Government's recommendation for usage of forex reserves

The Union Budget put forth a proposal to use "a small portion" of forex reserves to fund domestic infrastructure development. The proposal is based on an assumption that such a practice would not be inflationary in nature. Government has proposed establishment of two wholly owned overseas subsidiaries of IIFCL with the following objectives:

(i) to borrow funds from the RBI and lend to Indian companies implementing infrastructure projects in India, or to co-finance their ECBs for such projects, solely for capital expenditure outside India; and

(ii) to borrow funds from the RBI, invest such funds in highly rated collateral securities, and provide 'credit wrap' insurance to infrastructure projects in India for raising resources in international markets.

Usage of forex reserves for domestic projects may pose a challenge for RBI

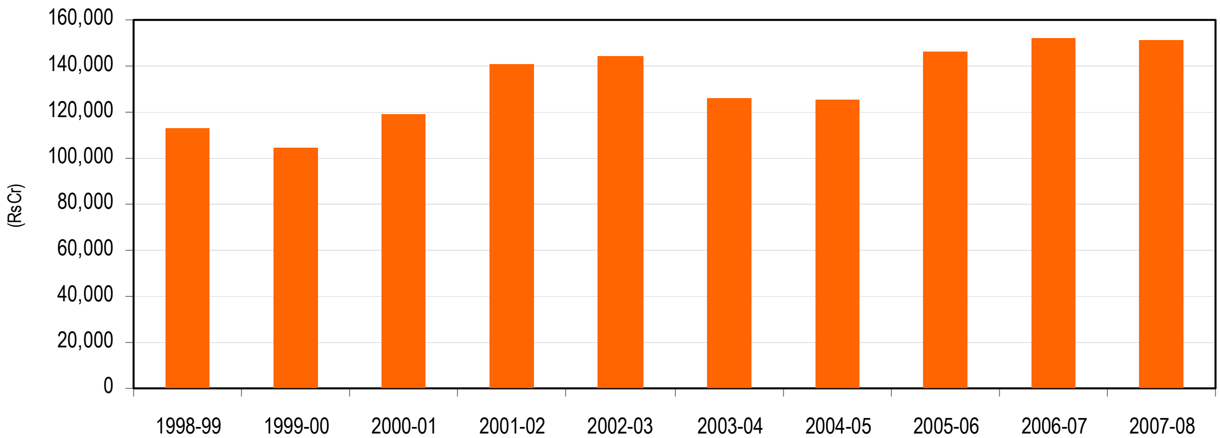
The Government of India would guarantee the loans given by RBI to these two subsidiary companies and the RBI would be assured of a return higher than the average rate of return on its incremental investment.

In our view, the proposal to use forex reserves to fund domestic infrastructure is unwelcome as nowhere else in the world, are forex reserves eligible for funding any domestic projects. This partially defeats the purpose of creating the reserves in the first place and will also pose challenges in monetary management to RBI. The proposal effectively creates a refinance window using the forex reserves and will add to domestic liquidity conditions.

IMF Guidelines for Foreign Exchange Reserve Management

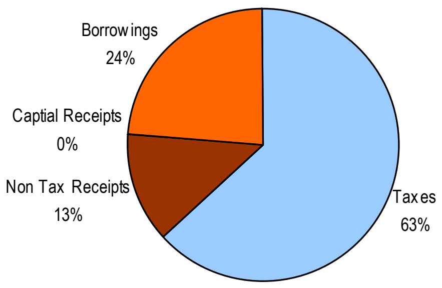
IMF has stated that pledging of foreign exchange reserves as collateral with foreign institutions to fund domestic or international projects leads to a liquidity risk. This is true in case where economy experiences shock and is unable to repay the debts. This in turn raises question on the country's credit worthiness. In its guidelines on forex reserves management, IMF says that "To ensure that reserves are available at the times when they are needed most, liquidity-which is the ability to convert quickly reserve assets into foreign exchange-usually receives the highest priority, albeit with a cost that usually involves accepting lower yielding investment instruments. Closely following is the need for the management and control of risks to ensure that asset values are protected. Market and credit risks, for instance, can lead to sudden losses and impair liquidity. Finally, earnings are an important outcome of the management of reserve assets. For some countries, they play a role in offsetting the costs associated with other central bank policies and domestic monetary operations, which among other things fund the acquisition of reserves. In other cases, such as where reserves are borrowed in foreign markets, earnings play an important role in minimizing the carrying costs of reserve assets. Accordingly, achieving an acceptable level of earnings should be a priority within clearly defined liquidity and risk constraints. In sum, the reserve management entity should seek to maximize the value of reserves, within the prudent risk limits that form the framework for reserve management, so that reserves are always available when they are needed. As a consequence, reserve asset portfolios tend to be highly risk-averse, with a consequent priority for liquidity and security before profit, or carrying cost considerations. This necessarily involves making a trade-off between risk and return in the context of setting reserve management priorities."

Figure 1: Fiscal Deficit



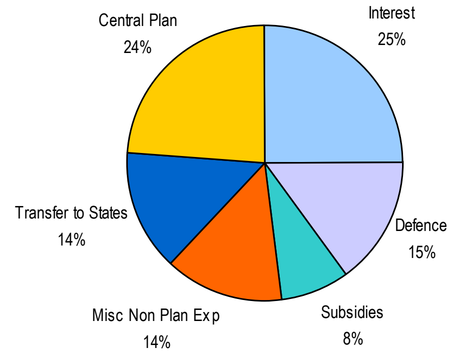
Source: IDBI Capital Fixed Income Research

Figure 2: How the Rupee is earned



Source: IDBI Capital Fixed Income Research

Figure 3: How the Rupee is spent



Source: IDBI Capital Fixed Income Research

Fiscal Deficit target reduced to 3.3% of GDP for 2007-08

Higher non-plan revenue expenditure led to slippage of fiscal deficit in 2006-07

The Budget Estimates of fiscal deficit for 2007-08 is Rs 150,948 cr, which amounts to 3.3% of GDP. This signifies a reduction of 0.4% from 3.7% level in 2006-07. The reduction in the fiscal deficit is in line with the Fiscal Responsibility and Budget Management Act, which mandate the Government to cut the fiscal deficit to 3% of the GDP by 2008-09. The revenue deficit for 2007-08 is targeted at Rs 71,478 cr against Rs 83,436 cr in 2006-07. The revenue deficit to GDP ratio is targeted at 1.5% for 2007-08, considerably lower than 2.0% in 2006-07.

Revised estimates on fiscal deficit stand at 3.7% for 2006-07 against budgeted 3.8%. However, the fiscal deficit as a whole number for 2006-07 has noted slippage. The fiscal deficit in percentage terms thus appears to be cushioned by a substantial growth in nominal GDP during 2006-07. The revised fiscal deficit figure rose by Rs 3,642 cr from a budgeted figure of Rs 148,686 cr. This was despite an increase of close to Rs 20,000 cr in revenue receipts. The rise in fiscal deficit could be attributed to an increase of almost Rs 18,000 cr in non-plan expenditure, decline in loan recoveries by close to Rs 3,000 cr and decline of close to Rs 3,000 cr in other receipts.

MSS ceiling increased

Liquidity expected to be impacted in light of increase in auctions under MSS

The annual ceiling under the Market Stabilization Scheme has been increased to Rs 80,000 cr from Rs 70,000 cr. Moreover, the budget for auctions under MSS for 2007-08 is considerably higher at Rs 141,135 cr, as against Rs 110,415 in 2006-07 and Rs 85,262 in 2005-06. The debt market may take the increase in auction amount and expansions in ceiling for MSS in a negative light. Higher amount of auctions under MSS would mean a higher amount of liquidity being sterilized from the market for a minimum tenor of 3 months. This would put an added pressure on an already volatile liquidity situation. A percentage rise in CRR during the current year has already sterilized close to Rs 27,500 cr of liquidity from the system. RBI would thus continue to play a crucial role as concerns liquidity management in 2007-08. Liquidity has remained prominently in a deficit mode during the past few months. Average daily infusions by RBI have been around Rs 11,000 cr.

Buoyant tax collection targets

Table 1: Revenue targets **(Rs Cr)**

Particulars	**2006-07 (RE)**	**2007-08 (BE)**	**Growth (%)**
Excise Duty	117,266	130,220	11
Customs Duty	81,800	98,770	21
Corporate Income Tax	146,497	168,401	15
Personal Income Tax	82,510	98,774	20
Service Tax	38,169	50,200	32
Other Taxes	1,606	1,757	9
Total Tax Collection	467,848	548,122	17
Less: Devolution to State Governments	120,377	142,450	18
Less: Transfer to National Calamity Contingency Fund (NCCF)	1,500	1,800	20
GOI's Net Tax Revenues	345,971	403,872	17

Source: Ministry of Finance

The tax receipts of GOI are projected to grow at 17% during 2006-07, as per the Budget Estimates. The estimates point to buoyancy in indirect tax collection through the excise and customs duty route, despite various cuts announced in the budget. The move was a step further towards achievement of bringing down the rates to East Asian levels. The Budget has provided for significant cut in customs duty level. The amount collected from customs duty collections is expected to grow by 21% in 2007-08. The excise duty collection would increase by 11%, over and above the announcement of various exemptions and cuts as regards excise duties. GDP is expected to grow at 8% - 9%, which would provide a boost to the tax collections. The

Indirect tax growth considerable despite announcements over excise & customs duty cut

growth projection for service tax is significantly higher at 32%, considering addition of some more services to the tax net. Budget proposes to include the outsourcing services for mining, commercial rental of immovable property, development of supply & content for telecom & advertising, asset management services and design services under the service tax net. The growth projection for corporate tax and personal income tax is at 15% and 20% respectively.

As concerns the non-tax revenue, the growth projections are moderate. The non-tax revenue target for 2007-08 is at Rs 82,550 cr against the receipts of Rs 77,360 cr in 2006-07. The Capital Receipts in 2007-08 are projected at Rs 43,151 cr, however this includes Rs 40,000 cr on account of proposed transfer of RBI's equity holding in State Bank of India. Net of this transfer the capital receipts actually show a decline in budget estimates for 2007-08 when compared to receipts of Rs 5,978 cr in 2006-07.

Figure 4: Revenue Analysis

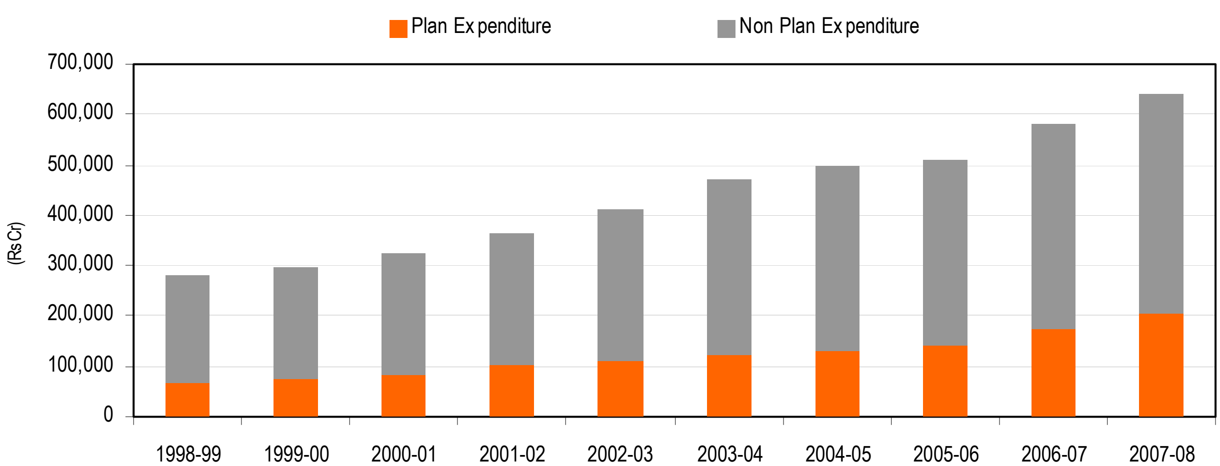
Source: IDBI Capital Fixed Income Research

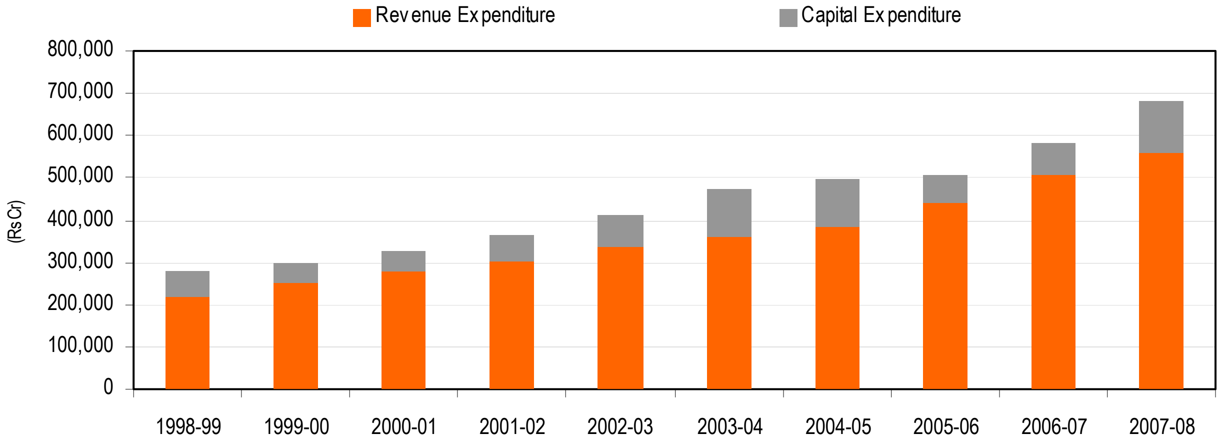
Expenditure Growth moderate

The total expenditure of GOI is projected at Rs 640,521 cr in 2006-07, excluding Rs 40,000 cr on account of proposed transactions relating to transfer of RBI's stake in SBI to the Government. The planned expenditure for 2007-08 is thus 10% higher than the expenditure of Rs 581,637 incurred during 2006-07. Plan expenditure constitutes 32% of the total expenditure, while the non-plan expenditure comprises of the balance 68%. Revenue expenditure is 87% of the total expenditure while capital expenditure is a modest 13%.

The budgetary support to Central Plan in 2006-07 is set at Rs 154,939 cr, forming 24% of the total budget expenditure. The budgetary support for Central Plan has grown by 19% over Rs 130,261 cr expended in 2006-07.

Figure 5: Expenditure Analysis





Source: IDBI Capital Fixed Income Research

Table 2: Fiscal trends over the last ten years **(Rs Cr)**

Particulars	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Tax Receipts	104,652	128,271	136,658	133,662	158,311	186,932	224,798	274,139	345,971	403,872
Non Tax Receipts	44,858	53,242	55,966	67,787	72,574	76,068	81,215	74,335	77,360	82,550
Capital Receipts	16,507	11,854	14,172	20,050	37,432	82,976	66,467	14,056	5,978	3,151
Total Receipts	166,017	193,367	206,796	221,499	268,317	345,976	372,480	362,530	429,309	489,573
Plan Expenditure	66,818	76,182	82,669	101,194	112,077	122,149	132,276	143,791	172,730	205,100
Non Plan Expenditure	212,520	221,929	242,942	261,259	300,887	349,787	365,406	364,914	408,907	435,421
Total Expenditure	279,338	298,111	325,611	362,453	412,964	471,936	497,682	508,705	581,637	640,521
Revenue Expenditure	216,459	249,136	277,857	301,612	337,748	361,308	384,352	440,295	506,767	557,900
Capital Expenditure	62,879	48,975	47,754	60,841	75,216	110,628	113,330	68,410	74,870	122,621
Fiscal Deficit	113,321	104,744	118,815	140,954	144,647	125,960	125,202	146,175	152,328	150,948
Revenue Deficit	66,949	67,623	85,233	100,163	106,863	98,308	78,339	91,821	83,436	71,478
Primary Deficit	35,439	14,495	19,501	33,494	29,017	1,699	-1,732	16,143	6,136	-8,047

Source: IDBI Capital Fixed Income Research

Glossary

Tax Revenues consist of both direct and indirect taxes. These include Income Tax, Corporation Tax, Wealth Tax, Customs Duty, Excise Duty, Service Tax and miscellaneous Taxes.

Non Tax Revenues comprise of interest received, dividends from Public sector units and departmental undertakings, dividends from Reserve Bank of India, grants received, fees and charges levied for services like Passport etc.

Non Debt Capital Receipts consists of recovery of loans, proceeds from disinvestment and sale of any assets.

Plan expenditure consists of Central Plan and Central assistance to plans of States and Union Territories. Central Plan is approved every year by the Planning Commission and includes all developmental expenditure like education, healthcare, rural development etc and investment in infrastructure like roads, ports, power projects etc.

Non Plan expenditure refers to expenditure incurred on interest payment, defence expenditure, pensions, subsidies, Central Police forces, grants to states and foreign governments and loans given. All expenses under this head are non-developmental in nature.

Fiscal deficit/surplus is the difference between the total receipts and total expenditure of the Government. The fiscal deficit is financed through borrowings from domestic and external sources.

Revenue Deficit is the difference between revenue receipts and revenue expenditure of the Government. Revenue expenditure is the expenditure incurred on day to day activities and excludes all expenses of investment or capital nature. Revenue deficit is normally taken as an indicator of the deficit incurred due to non-developmental expenditure.

Primary Deficit is computed by reducing the interest payments of the Government from the fiscal deficit.

Notes

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