INDIAN MID CAP

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Budget preview: restoring India's fiscal health

Given that a copy book economic recovery is underway, the Government is likely to use this budget to put India back on the course for a 4% fiscal deficit. The only sectors that might benefit from the Exchequer's purse are Power, Infra, Defense and Education. The rest will have to make do with tall promises of a simplified tax structure that in future years might lower the tax burden.

The main thrust areas of the budget

- Cut the budget deficit for FY11 to 5.5%. However, in absolute terms, the Government is likely to borrow the same amount in FY11 as in FY10.
- No increase in Government expenditure other than in Power, Infra, Education and Defense.
- Lay down the bulk of the groundwork for the Direct Tax Code (DTC) and the Goods and services Tax (GST).

The table below summarises the announcements likely to impact the broader economy. For sector-specific announcement please turn to Table 3 on Pg 5.

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Table 1 Budgetary arithmetic and significant announcements

Budgetary considerations	Likely?	Rationale	Reform and other significant measures	Likely?	Rationale
Taxation measures					
Direct tax			Higher disinvestment targets	√	Heart of the Govt. is in reform
Expect Govt. to lay the ground for implementation of DTC	√	Expect measured steps in this direction.	Higher spend in infrastructure	√	Infrastructure is a key priority
Reduction in personal income taxes (including increasing the tax slabs and reducing rates)	√	In the direction of DTC proposals	Higher spend in rural and social sector	×	We expect announcements, but no action
Indirect taxes			**Proposed by Industry bodies**		
Rollback in concessions given in taxes as part of stimulus measures (2-4% increase in excise, cenvat)	√	Stimulus withdrawal, alignment with GST	Bring down corporate tax rate to 25%	√	Reform measures to help industry
Steps to introduce of Goods and Services Tax	√	Reiterate strong intent but take baby steps, timeline not so significant	Extension of benefit under Section 72A of I-T Act in respect of amalgamation or demerger to all businesses	√/×	
Expenditure measures					
Cuts in rural and social spending	√	Post election consolidation	Introduce GST - Firm commitment on timeline, single rate, uniform implementation across states	√	Budget to make steps in the direction and contain significant announcement
Increase in defence and internal security	√	Priority due to volatile situation	Strengthening of the PPP for infra projects and for highway development	√	Infrastructure is a key priority
Gross budgetary support to plan @15%	√	The best compromise worked so far	Restoration of Minimum Alternate Tax (MAT) rate to 10% from 15%	×	Conflicts with DTC principles
Fiscal Balance					
Fiscal deficit for FY10 (Revised) @6.5% Fiscal deficit for FY11 (Proj) @5.5% Net Government borrowing to remain at Rs. 3.5 tn	√	Govt. firmly on fiscal consolidation route			

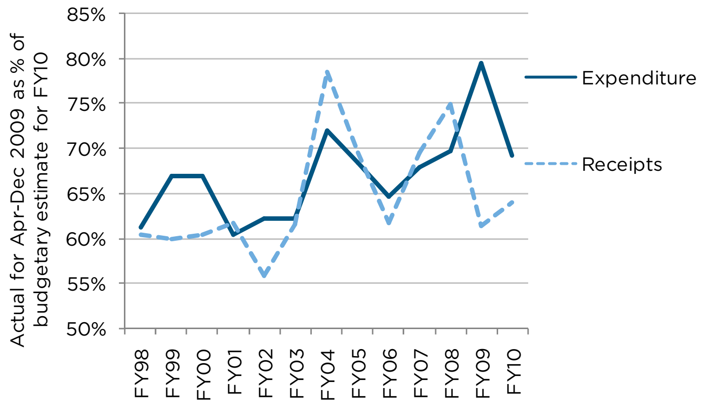
Source: Financial press, Execution-Noble.

Stimulus withdrawal is already underway on the spending side

The latest trends indicate an improvement in India's fiscal situation. The Government has caught up on the receipts side with the latest figure on direct tax indicating a revival of tax collections in Q4FY10 raising hopes of meeting the direct tax target. However, as highlighted repeatedly in our various notes there have been severe spending cuts across various categories of expenditure (see Figures 1 & 2). Notably the spending pattern upto Apr-Dec 09 indicates that all categories of expenditure have been pruned back whilst Government was also a beneficiary of prevailing lower interest rates that kept interest costs low despite a significant jump in market borrowing (see Figure 2).

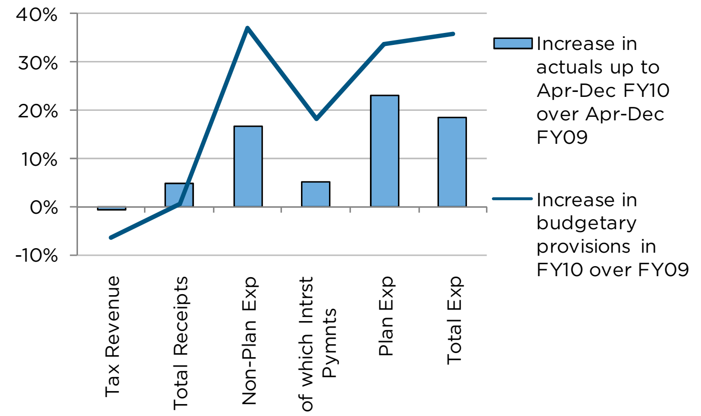
Tax collections has improved off late.

Figure 1 Whilst tax receipts are catching up, a severe spending cut back is underway



Source: Controller General of Accounts, Execution-Noble.

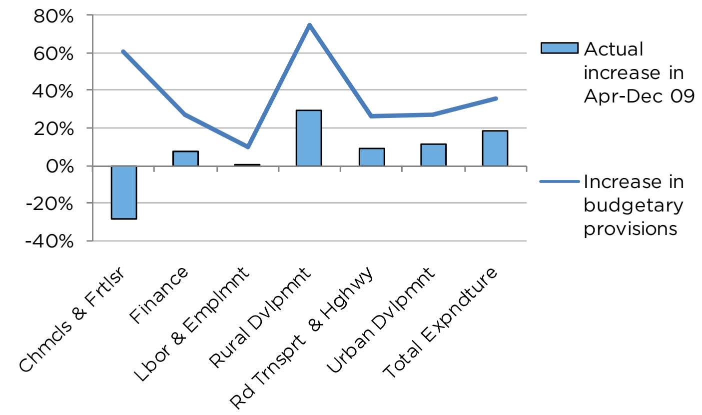
Figure 2 Cutback in all categories of spending compared with the budgetary provisions



Source: Controller General of Accounts, Execution-Noble.

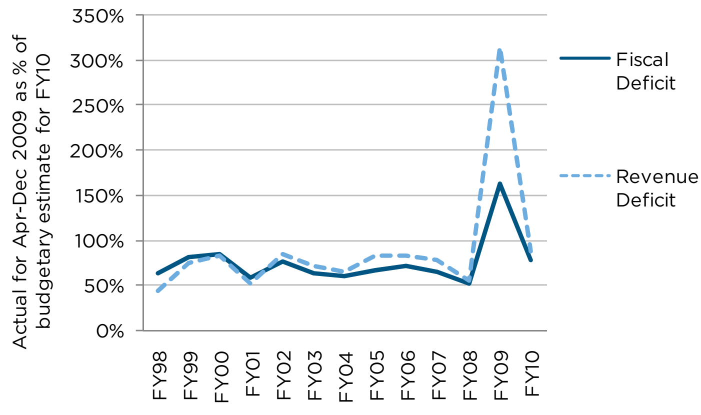
Another aspect of spending pattern has been the significant cuts by the ministries responsible for the delivery of most subsidy and socially oriented programmes (see Figure 3). The extent of slack can be gauged from the reports that nearly Rs.1 tn is lying unused with various Ministries. Thus the improvement in the revenue collection coupled with a determined effort to reduce spending has resulted in a sharp reduction of deficits from the high they reached in the crisis year (see Figure 4).

Figure 3 Significant drop in subsidy and rural programmes – there are no holy cows post election



Source: Controller General of Accounts, Execution-Noble.

Figure 4 We are past the stimulus year of FY09 and fiscal consolidation is already underway



Source: Controller General of Accounts, Execution-Noble.

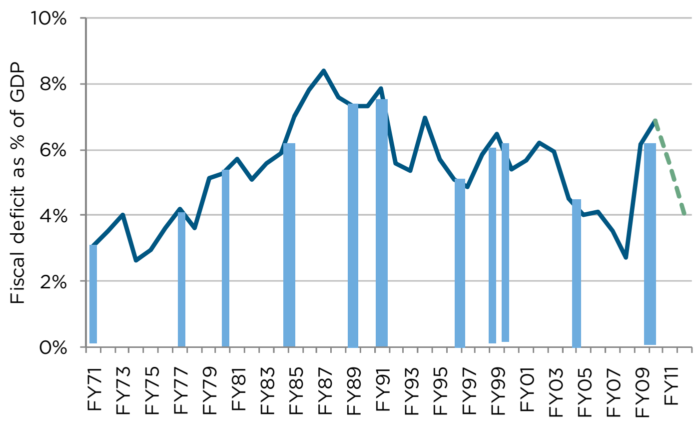
Hence a fiscal correction is imminent

The interplay of the political business cycles (that results in swelling of fiscal deficit during the crisis year followed by opportunistic cuts post elections) have played out on most occasions in India. The pre-election spending bonanza was only compounded by the need to provide stimulus measures as a crisis response resulting in derailment of the fiscal goals outlined under the Fiscal Responsibility and Budget

Management (FRBM) Act. The conclusion of elections, signs of economic recovery (with the latest IIP figures for Dec 09 showing 17% growth in industrial production) and the significant spending squeeze already underway, raises hope that the fiscal correction path chalked out by the Government will be adhered too. With the Thirteenth Finance Commission (recommendations of which would be tabled in the budget session of the Parliament) already drawing a roadmap for return to the revised FRBM path, India is on a path of fiscal rectitude. The fiscal deficit for the three years - FY10, FY11 and FY12 is likely to stay on course at 6.5%, 5.5% and 4%, respectively (see Figure 5).

The Government is likely to stay on the course of fiscal rectitude.

Figure 5 Raises our confidence on the consolidation path announced by the Government



Source: Labour Bureau, Noble.
Note: Shaded area represents election years.

Table 1 The borrowing programme for FY11 is expected to sail through with moderate credit growth outlook and subscription from insurance cos.

	Borrowing details	Centre (Rs. bn)	State (Rs. bn)	Total (Rs. bn)
1	Net market borrowing for FY10	3,510	1,520	5,030
2	add redemptions in FY10	1,000	150	1,150
3	Gross market borrowing for FY11 (1+2)	4,510	1,670	6,180
4	Net market borrowing for FY11	3,500	1,300	4,800
5	add redemptions in FY10	1,200	200	1,400
6	Gross market borrowing (4+5)	4,700	1,500	6,200
	Financing mechanism			
7	Estimated absorption by banks			3,000
8	Estimated absorption by insurance, provident funds, mutual funds etc.			3,000
9	Overall shortfall			200

Source: RBI, Execution-Noble.

However, the Government's borrowing in absolute won't fall

Although the Government has chalked out a sequential deficit reduction plan, it needs to be recognised that the absolute level of Government borrowing will nonetheless remain higher. Thus the estimated net market borrowing for FY11 remains roughly of the same order as FY10 (Rs.3.5 tn). With banks' deposit base growing at ~20% and insurance companies reporting significant increase in gross premium, such a programme would have normally sail through. However, with somewhat higher redemptions scheduled for FY11 and with the RBI's support in the form of wide scale open market operations largely waning, there may be a narrow shortfall of Rs.200 bn in funding the borrowing programme (see Table 1). This shortfall can easily met by RBI intervention.

Continued high borrowing by itself is not a source of hardening bond yields

Whilst the borrowing programme is unlikely to put pressure on yields to harden, there are a few other factors which might result in bond yields inching up. For one with policy rates likely to harden from April 2010 (we expect a 50 bps increase in the repo and reverse repo to begin with), bond rates are likely to go up. Secondly, with inflation rapidly running into the double digit territory, the yield curve is also likely to steepen.

Besides deficits, what are the thrust areas for the FY11 budget?

The Government has embarked upon three very significant areas of reform on the revenue side. These involve the Direct Tax Code (DTC) on the direct tax front, the Goods and Services Tax (GST) on the indirect tax side and renegotiations of tax treaties with 77 countries. Each of these are path breaking reforms in their own merit with the common theme being the simplification of the tax structure that aims at reducing the tax burden while enforcing better compliance.

It is evident that such far reaching tax reforms are likely to disrupt the revenue side in the short term besides facing several implementation challenges. However, we expect significant announcements (short of a timeline) regarding all three in the 26th Feb budget. With a strong commitment for deficit reduction, this imposes a hard budget constraint on the expenditure side of the Government accounts. Hence we expect that while reform measures might gain ascendency in the policy priorities of the Government, expenditures in areas except (security and infrastructure) would not receive any boost from the budget (see Table 2).

Table 2 Budgetary arithmetic and significant announcements

Budgetary considerations	**Likely?**	**Rationale**	Reform and other significant measures	**Likely?**	**Rationale**
Taxation measures					
Direct tax			Higher disinvestment targets	√	Heart of the Govt. is in reform
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Cuts in rural and social spending	√	Post election consolidation	Introduce GST - Firm commitment on timeline, single rate, uniform implementation across states	√	Budget to make steps in the direction and contain significant announcement
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Source: Financial press, Execution-Noble.

Whilst market may take heart from the tight deficit numbers, the slew of reform measures and the steps towards a reduced tax burden (as a corollary of tax reforms), the withdrawal of stimulus measures (particularly the indirect tax benefits) might be perceived negatively by the market. Moreover, those banking on sector specific concessions are likely to be disappointed (see Table 3). This is because the introduction of far reaching tax reforms, the ground for which will be laid in the FY11 budget, will leave less headroom for such sector specific concessions going forward. That being said, India's Power, Infrastructure and IT would continue to receive continued Government importance. Auto and pharma might be the new focus areas for the Government given India's emerging potential in these areas.

Table 3 If wishes were horses and Pranabdada the Santa Claus

	Industry desire	Likely?	Rationale	Impact	Cos.
Education	Moderate increase in education budget. Education companies expect the minister to increase allocation to education towards existing computer literacy, computer aided learning and teacher training programs.	√	Chief Economic Advisor, Prof. Kaushik Basu effect.	+	All domestic Education firms Educomp, Everonn, NIIT
IT		√	**The Nandan Nilekani effect?**		
	Extension of the STPI tax holiday Whilst the industry's leading lights are not in need of tax benefits, newer and smaller firms that haven't enjoyed tax benefits for a long time would want it extended to get a level playing field with their larger peers. Nasscom is likely to continuing to lobby for an extension highlighting the initial days of recovery for the industry and threat from other geographies such as Philipines, China and Eastern Europe.	×	The IT industry is mature and has benefitted from tax sops for over a decade that is unlikely to inspire the FM to extend the tax holiday.		All IT exporters- HCLT, Patni, 3i Infotech, Rolta
	Roll back of Minimum Alternate Tax (MAT) for STP firms	×	Conflicts with DTC principles		
	Advance Pricing Agreements (APAs) and Safe Harbor Provisions under Transfer Pricing to provide predictability and tax certainty	√/×			
	Clarification on withholding tax obligations in the context of certain recent Court rulings on software transactions	√/×			
	Revert back to the erstwhile system of 'gains at the time of actual sale' of shares vis-à-vis the current system where tax is levied at the time of 'allotment' as well as 'sale of shares'	√	Desirable		
	Removal of dual levy of tax on software transactions under the service tax and VAT legislations	√	In line with GST principle		
	Address delays in grant of refund on service tax refunds (on input services used for exporting IT / ITES services)	×	Govt. has issued clarificatory circular, implementation tardy		
Bank		√	**Capital injection and extension of repayment schedule of debt relief scheme - positives**	+	PSBs
	Tax benefits on bank issued infrastructure bonds	×	High fiscal cost		
	Clarity on World bank led $2bn PSB recapitalisation scheme. Tier-2 PSBs expected to benefit.	√		+	Tier II PSBs
	Extension of the farm loan waiver/debt relief scheme to June'10.	√/×	A majority of PSBs had not made provisions on NPAs arising from farm loans in Q3.	+	PSBs
	Allow higher deduction for provision made by banks towards bad and doubtful debts	×	Long pending demand, might be ignored again		
	Clarification on the what constitute "head office expenditure" Indian branches of foreign banks and revisit the ceiling for tax purpose (5% of the adjusted total income of the Indian branch)	√/×	The DTC proposes to change the limit of deduction to 0.5% of sales		
	Clarity in tax treatment of securitisation transactions	√/×	Long pending issue		
	Extension of tax benefits currently available to 5-yr deposits to 3-yr deposits to bring it at par withEquity Linked Savings Schemes offered by mutual funds	×	The issue of bank deposits vs. mutual funds instruments have died down		
FMCG		×	**Headwinds ahead**		
	Excise duty hike in cigarettes and alchohol	√	Self explanatory	-	FMCGs
Retail		×	Unlikely to be directly benefitted through tax exemptions		
	Retail acquiring an industry status	√	Hard lobbying may yield result	+	All
	Abolition of Service tax on renting of immovable property	×	Govt. is trying to widen the service tax net		
	Exempt or simplify refund of Special Additional Duty of Customs (SAD)	×			
	Legislation for franchise model	√	A workable compromise less than permitting FDI		
Realty		×	**Housing may get higher tax benefit**		
	An exclusive regulator for the sector	√			
	Easing norms for private equity participation	√	Already under consideration		
	increasing the deduction currently available with regard to interest and principal repayment on housing loans	√	Existing limits are small	+	Housing Finance companies (LIC Housing)
	Change in tax holiday period from date of notification to date of operations for SEZs	√			
	Commercial lease rentals out of the servies tax net or alternatively allowing deduction for the amount of service tax paid	×	In conflict with GST principle		

	Tax incentives for development of healthcare, infrastructure, media and entertainment infrastructure, theme/ amusement parks, education and sports	×	Govt. does no more look at tax policies for achieving all objectives		
Infrastructure		√	**Strong political imperative**		
	Reintroduce the tax exemption on interest income and capital gains earned on investments in infrastructure by companies	×	Funds and private equity to increase investment in Infra		Developers
	Clarificatory endorsement of the availability of tax holiday presently available to new infrastructure projects to modernisation/ expansion projects	√/×			
	Exempt all infrastructure companies from payment of MAT (currently 17%)	×	Increase private interest		All
	Single window clerance for PPP	×	Larger investment by private sector		All
	Offer airports the same 10 year tax	√/×	Political imperative		GMR/GVK
Power		√	**Likely to be the thrust area**		
	Tax holiday that other infra projects in India get	√	Sunset clause may be extended for one more year, given many projects are ongoing		ALL
	Removal of exemption of import duty on power equipment for power projects above 1,000 MW	√	Govt wants to stop the exodus of Chinese equipment dumping in India. It will be negative for companies using Chinese equipments as O&M will now have to be done by Indian companies	–	Adani Power, Lanco, KSK, Sterlite Energy
	Private merchant players to get a credit/offset on the tax paid on input costs (both on the capital side and on the operational side).	×	Already 80 IA exemption is available	–	All
Stock broking		√	**May be a passive beneficiary**		
	Keep corporate income tax stable	√	Revenue buoyancy, alignment with DTC		All
	Reduce Securities transaction tax (STT) by half to around 6 bps from existing 12 bps	×	Source of idle revenue for Govt.		
	Scrap dividend distribution tax	×			
	Clarity on long-term capital gains versus business income emanating from stock market transactions	×	Clarity may come without reducing the tax burden		
Automobile		√	**India's growing prowess as auto hub may help**		
	Continue with the excise duty cuts, accelerated depreciation for commercial vehicles, easing of bank liquidity, softening of lending rates	×	Auto industry posting much healthier nos.		
	Extension of sunset clause for exemption of export profits beyond March 2011 under Section 10B of the Income Tax Act	√	As India is emerging as a auto hub		
	Susidy for manufacturing and tax benefits on vehicles running on alternative energy	√/×	Might be partially granted for India's obligation on climate change		
	Tax breaks for R&D service providers for automotive and auto component manufactures	√	As India is emerging as a auto hub		All
	Introduction/implementation of the Safe Harbor Rules (specifying the acceptable range of margins for auto companies having regard to the prevailing market trend)	×	Difficult to provide in-built counter cyclical protection to a particular industry		
Health and Pharma		√	**Benefit of R&D may be extended**		
	Significant increase in health expenditure to enhance health infrastrucutre	×	Very poor record, fiscal consolidation		
	Extention of tax holiday provided to hospitals set-up in rural areas from 5 years to 10 years	√/×	Would be a pleasant surprise if done		
	Inclusion of expenditure incidental to research carried outside R&D facility in India or in any foreign country, within the ambit of weighted deduction available for in-house R&D	√	Catching up with China		
	Research tax credits to offset future tax liability	√/×	India innovation vs. tax rationalisation		
	Extension of the list of life saving drugs eligible for customs duty exemptions and reducing the duty on medical devices	×			
	Removal of accumulation of Cenvat credit in the books, on account of difference in the duty structure of APIs and FDFs	√	In line with GST principle		
	rationalization of Value Added Tax (VAT) across states	√	In line with GST principle		

Source: Financial press, Execution-Noble.

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