Asia Economics Flash

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A curtain-raiser to the 2007-2008 Indian budget

- In our view, the 2007-2008 budget to focus on 4 key themes:

  1. *Inflation* – through customs duty cuts across-the-board and selective excise cuts.

  2. *Infrastructure and social spending* – through increased allocation to health and education and infrastructure, and incentives to companies.

  3. *Continued fiscal consolidation* – to meet the Fiscal Responsibility Act, lower borrowing requirements and dampen demand pressures.

  4. *Agriculture and labor-intensive sectors* – through incentives to agriculture-based sectors, food processing, and employment generating sectors such as leather, textiles, and footwear.

We raise the curtain on the 2007-2008 budget by first providing a simple guide to India's public finances. We then identify and elaborate on what we believe are the 4 key themes for this year's budget.

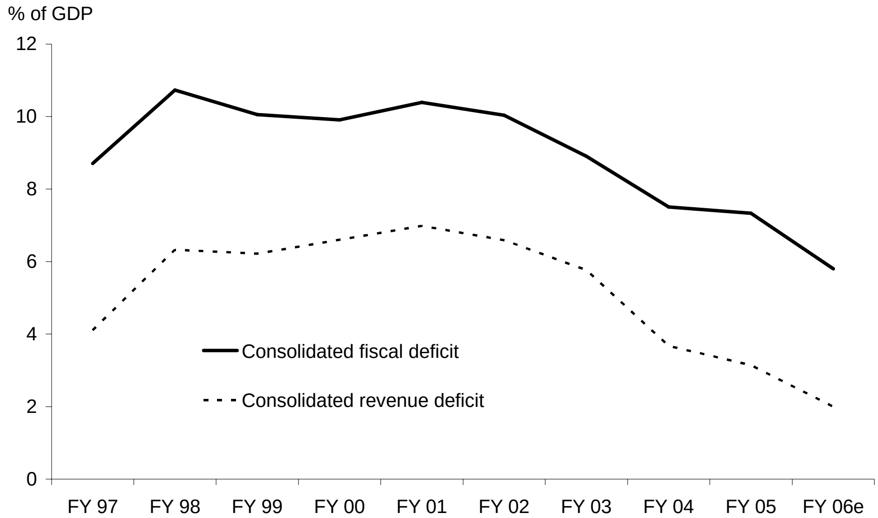
We expect the 2007-2008 budget to continue the recent trend of reducing the local hype and glamour associated with it and aiming to present it more as an annual book-keeping exercise. India's public sector has traditionally been a dominant player in the economy, and hence its finances have had a major bearing on the macroeconomic situation. In the pre-reform era of the licence-permit raj, high taxes, and a plethora of exemptions, an incentive in the budget could make the difference between success and failure for a company. The annual budget therefore received an inordinate amount of attention by corporates and the media. The government's role in the economy has however, been slowly declining as cumulative reforms have trimmed the public sector and reduced taxes.

A short guide to India's public finances

We expect India's consolidated fiscal deficit to be about 6% of GDP in 2006-2007, down from a peak of about 10% of GDP in 1998-1999. As Exhibit 1 shows, the deficit has been on a declining trend since 2003 after the passage of the Fiscal Responsibility and Budget Management Act (FRBMA) in the same year.

The FRBMA mandates the central government (centre) to reduce its fiscal deficit to 3% of GDP and to completely eliminate the revenue deficit (the difference between current expenditures and revenues) by 2008-2009. Similarly, 24 of the 29 states have also enacted similar obligations – fiscal deficits of 3% of GDP and zero revenue deficit by 2008-2009.

Exhibit 1: Fiscal deficit has been declining in line with FRBMA targets



Source: CEIC, Goldman Sachs Economics Research.

The centre and states are well on their way to fulfilling their FRBMA targets on fiscal deficits. For 2006-2007, we expect the fiscal deficit at the centre to be 3.3% which is a remarkable over-performance on the budget estimate of 3.8%. The zero revenue deficit target however, seems a long way away, as we expect the revenue deficit (RD) to be about 2%.

At the state level, the picture is encouraging as deficits have gradually come down. This year, the combined deficit will be lower than that mandated by the FRBMA. Thus, the states have met their target a full 2 years earlier than envisaged. Our key concern is not the overall deficit but the abysmal provision of public services, especially in the social sectors of health and education.

Exhibit 2: The centre's revenue deficit is a cause for worry

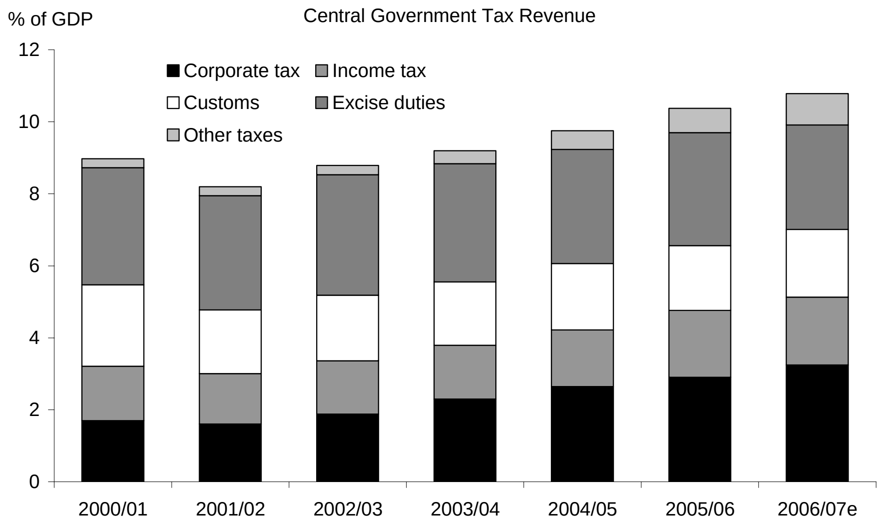
	Central government		State governments	
(% of GDP)	**Gross fiscal deficit**	**Revenue deficit**	**Gross fiscal deficit**	**Revenue deficit**
FY1997	5.8	3.0	2.9	1.1
FY1998	6.5	3.8	4.2	2.5
FY1999	5.4	3.5	4.7	2.8
FY2000	5.7	4.1	4.3	2.5
FY2001	6.2	4.4	4.2	2.6
FY2002	5.9	4.3	4.2	2.2
FY2003	4.5	3.6	4.5	2.2
FY2004	4.0	2.5	3.5	1.2
FY2005	4.1	2.7	3.2	0.5
FY2006E	3.3	2.0	2.5	0.0

Source: CEIC, Goldman Sachs Economics Research.

Though declining, the consolidated fiscal deficit in India remains high by international standards. Indeed, the actual deficit is higher than acknowledged due to some liabilities of the government which are not treated as debt in the budget numbers, the most important of which are oil bonds which add a further 0.7% of GDP to the deficit. Thus, the government remains a big borrower in domestic markets, impacting significantly on aggregated demand and interest rates.

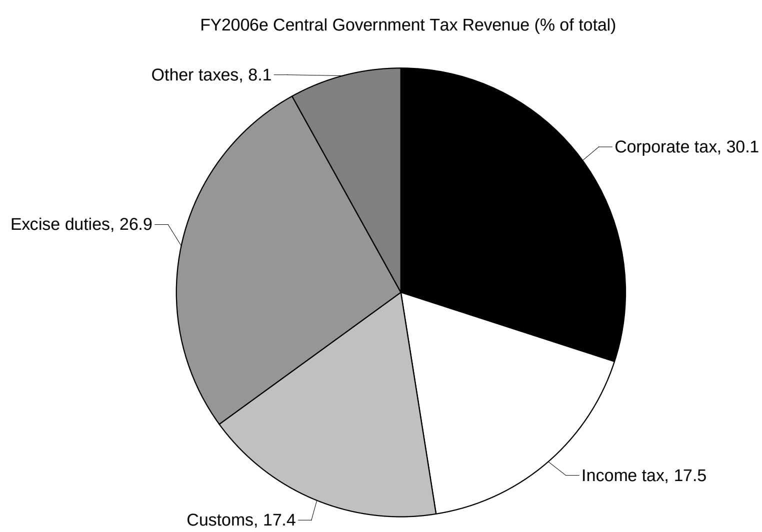
India's tax structure is skewed towards indirect taxes such as customs and excise duties. Even though their share is declining, indirect taxes as a proportion of total taxes in India remains high by international standards. Given the current buoyancy in direct taxes, which has increased by about 40% in 2006-2007, we believe that a further reduction in the proportion of indirect taxes is desirable.

Exhibit 3: Corporate and income tax collections have been rising…



Source: CEIC, IMF, Goldman Sachs Economics Research.

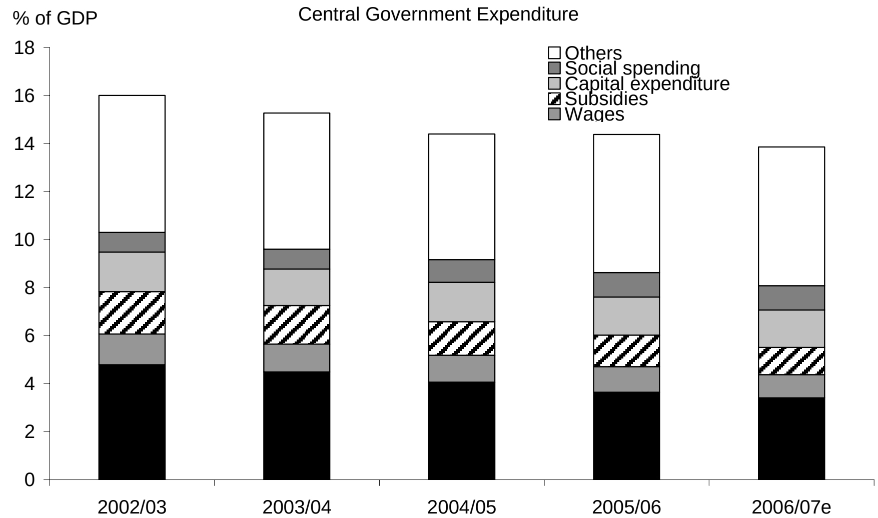
Exhibit 4: …but excise and customs duties still comprise a large proportion of taxes



Source: CEIC, IMF, Goldman Sachs Economics Research.

The expenditure composition of the government is biased towards current rather than capital expenditures. We believe that too much goes into subsidies and interest payments, and too little into social spending on health and education or on infrastructure.

Exhibit 5: Capex and social spending need to increase



Source: CEIC, IMF, Goldman Sachs Economics Research.

Theme #1: Inflation

This year's budget comes at a time when inflation is at a 2-year high and concerns about rising prices dominate the political arena. The causes for inflation are supply-side constraints, especially in food, some demand pressures, and base effects. Fiscal policy can help alleviate the first 2. Hence, we expect significant fiscal action to reduce prices. The attack on inflation is likely to be 3 pronged: 1) a reduction in customs tariffs across the board; 2) a reduction in certain excise duties; and 3) a reduction in the fiscal deficit to reduce demand pressures. These actions are not mutually inconsistent as the current revenue buoyancy has given the government the fiscal space to lower indirect taxes.

We expect peak tariffs to be reduced to 7%-8% from 12.5%, broadly in line with ASEAN peak tariffs. We believe the reduction in import prices and the consequent increase in competition will reduce pricing power of producers and help dampen inflation. To reduce the wedge between production costs and final prices, the government is likely to reduce excise duties on a range of goods. We expect an excise duty cut in petroleum products.

Theme #2: Infrastructure and social spending

We expect the budget to focus on the infrastructure and social sectors. Given the poor state of power, water, ports, roads, and airports and the potential impediment to India's growth, we expect the budget to have significant provisions for infrastructure, including improvements in the regulatory environment and tax sops to encourage long-term financing of infrastructure projects.

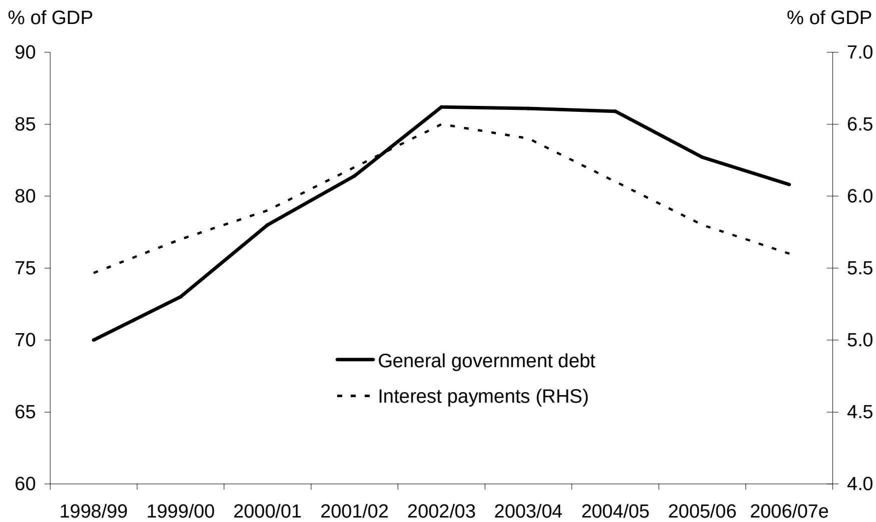
India's inadequacies in health and education are well documented. The allocation for these sectors compare abysmally with its peers. Not only is there a problem of spending in absolute terms but also the efficiency of spending leaves a lot to be desired. We expect the budget to focus on increasing the amount of social spending and to emphasize better delivery of programs such as the universal elementary education campaign (Sarva Shiksha Abhiyan). Secondary education is likely to be prioritized as drop-out rates are very high.

Theme #3: Fiscal consolidation

We expect the current revenue buoyancy and expenditure restraint to continue in 2007-2008, albeit at a slower rate, allowing continued fiscal consolidation in line with FRBMA targets. The losses from customs duties are likely to be balanced by direct tax buoyancy. We do not expect an increase in fiscal profligacy, implying that the government's borrowing program will be curtailed, leading to a lesser need to finance its deficit. This will put a dampener on yields. As interest rates are heading north due to the inflation induced monetary tightening, the absence of a declining fiscal deficit would have caused a large increase in yields. On balance, we expect bond yields to increase slightly in the near-term as the effects of higher inflation-induced monetary tightening outweigh lower fiscal deficits. However, over a 12-month horizon we expect declining fiscal deficits to have a larger effect, keeping yields at current levels.

India's debt is declining, and given the favourable differential between nominal GDP and interest rates, in all but the most trying circumstances, the debt is sustainable. However, the debt levels remain high and are a cause for vulnerability. It is the revenue deficit that is a cause for worry as it shows the surplus of current consumption over revenue. Thus, the government is using borrowed funds not for capital investment that will yield future income but for current consumptions such as salaries, subsidies, and pensions. Thus, continued fiscal consolidation is an imperative.

Exhibit 6: Government debt and interest payments are on a declining trend



Source: CEIC, IMF, Goldman Sachs Economics Research.

Theme #4: Agriculture and labor-intensive sectors

We do not expect any major changes in the tax system. As this is a mid-term budget, and given the revenue buoyancy and concerns about inflation, the focus is likely to be on consolidating the tax reforms introduced in previous budgets by the current administration.

Some tweaking of tax rates and incentives can be expected, as can the removal of some exemptions to broaden the tax base. For instance, we expect tax sops to infrastructure companies, food processing, agriculture-based companies, and employment-generating industries such as leather, footwear, textiles and clothing. We also expect more broadening of the tax base by including more services into the service-tax net, and by some removal of generous exemptions to charities.

The gradual move to a country-wide Goods & Services Tax is likely to be abetted by a cut in the Central Sales Tax to 3% from 4% on the inter-state movement of goods.

The tax administration is likely to be beefed up further. At least some of the recent increase in tax revenues can be attributed to improved administration, primarily the Tax Information Network, the setting up of large taxpayer units, and better-targeted audits. We expect these improvements are expected to continue.

What would be left out?

We do not expect any major reform push in this year's budget. Given that it is a mid-term budget and elections are due in several important states this year, with the general election due in 2009, the window for an acceleration of contentious reforms is fast closing. At any rate, we do not expect the 2007-2008 budget to be a forum for any movement on much-needed reforms such as any further privatization, labor reforms, pension reforms, financial sector reforms to develop bond and derivative markets, and the removal of foreign direct investment caps in key sectors such as insurance. We do not expect any major changes in the tax system as discussed above nor any substantial reforms in subsidies. With the government on the back-foot on inflation, it is unlikely to have the stomach to take on yet more contentious issues.

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