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Goldman Sachs Global Economics,
Commodities and Strategy Research
at https://360.gs.com

Tushar Poddar
tushar.poddar@gs.com
+91 22 6616 9042

Vishal Vaibhaw
vishal.vaibhaw@gs.com
+91 80 6637 8602

India Union Budget—a fiscal promise to keep and miles to go before it succeeds

- In the Union Budget for FY12, the government announced a reduction in the fiscal deficit to 4.6% of GDP from an estimated 5.1% in FY11, ahead of market expectations.
- The deficit reduction is based on revenue buoyancy and keeping expenditures essentially flat in nominal terms, which leads to a lower net market borrowing of Rs3.4 trillion, lower than market expectations.
- We think, however, it will be difficult for the deficit targets to be met as expenditures have been under-budgeted and revenues have been over-budgeted. There are no new taxes or increases in tax rates. The expenditure targets are ambitious, especially on subsidies. Oil subsidies in FY12 are 40% lower than the oil subsidies in FY11.
- On the reform front, the budget was more positive especially on opening up the capital account and on firm road maps for the implementation of the direct tax code and direct cash transfers of subsidies.
- All in all, we think the budget is an incremental positive for the INR due to the capital account easing measures, and neutral for bonds and equities given that there is sufficient uncertainty on the government meeting its fiscal targets.
- Our sector analysts have provided detailed takeaways on the budget's impact for their respective sectors. We think the budget is positive for cement, infrastructure, autos, and mildly positive for financials; and negative for iron ore exporters, oil-marketing and IT companies.

The Union Budget for FY12 correctly emphasizes fiscal consolidation. We, however, think that the fiscal targets could be difficult to achieve. Without any new taxes or reforms in the subsidy regime, we find it difficult to see how the government will stick to its revenue and expenditure targets.

The budget assumes a tax revenue increase of 18% without any new taxes or big increases in the tax base (see Exhibit 3 for the main measures in the budget). The government expects the removal of some exemptions on excise duties and increasing the service tax base to nullify increased income tax exemptions and reductions in corporate tax surcharge rates. We think these projections are at risk, especially if nominal GDP growth surprises on the downside.

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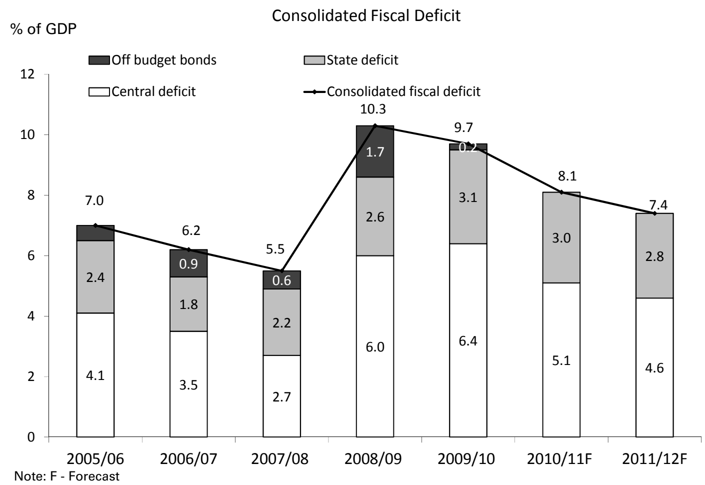
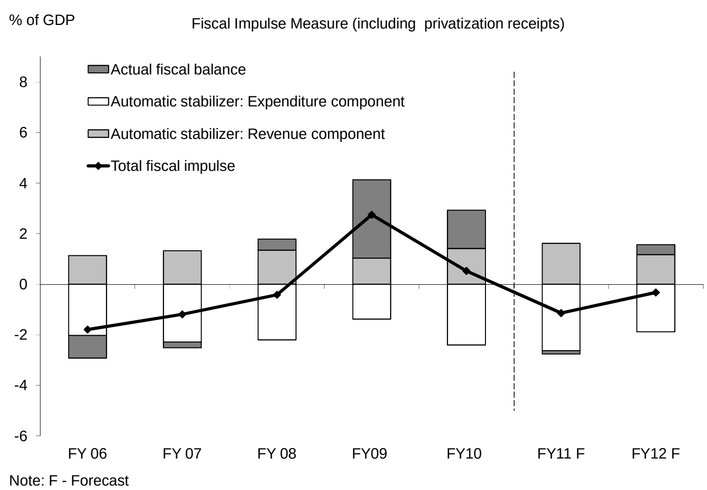
On expenditures, the budget has reduced capital spending while current spending is expected to grow at a mere 4.1%. Subsidies are expected to decline 13%, with oil and fertilizer subsidies declining and food subsidies remaining unchanged. With rising oil prices, and a food security bill potentially to be introduced later in 2011, to us, these subsidy numbers look ambitious at best.

Exhibit 1: The fiscal deficit is gradually coming down driven by privatization and one-off revenues



Source: Ministry of Finance, CEIC, GS Global ECS Research estimates.

Exhibit 2: Fiscal Impulse to remain negative in FY12, but less so than in FY11



Source: Ministry of Finance, CEIC, GS Global ECS Research estimates.

Impact on growth

Our estimation of the fiscal impulse remains negative in FY12, but less so than in FY11. According to the budget estimates, the fiscal deficit is expected to decline to 4.6% of GDP in FY12 from 5.1% of GDP in FY11. Total expenditures are budgeted to fall to 14% of GDP from 15.4% of GDP, which will be the chief driver of the removal in stimulus. Therefore, the government will be a net drag on GDP growth in FY12, although that drag could be lower if the deficit targets are exceeded as we expect.

Exhibit 3: The budget proposals at a glance

Tax proposals	Exemption limit for the individual taxpayers enhanced from Rs1,60,000 to Rs1,80,000 Current surcharge of 7.5% on domestic companies proposed to be reduced to 5% Minimum Alternate Tax (MAT) raised from 18% to 18.5% Tax incentives extended to attract foreign funds for financing of infrastructure Additional deduction of Rs20,000 for investments in long-term infrastructure bonds proposed to be extended No change in Central Excise Duty, maintained at 10% Service tax remained at 10% Foreign Dividend Tax to be cut to 15% for Indian companies SEZs to come under MAT
Agriculture	Provision of cash subsidy in fertilizers and kerosene Direct credit to farmers increased from 3 lakhs 75 thousand crore to 4 lakhs 75 thousand crores 3% interest subsidy on farm loans to farmers Mulling nutrient-based subsidy policy for Urea
Infrastructure	Allocation of Rs2.1 trillion for infrastructure in 2011-2012 Tax free bonds of Rs300 billion proposed to be issued by government undertakings during FY12 In FY12, IIFCL disbursements target up to Rs250 billion Fertilizer sector will get an infrastructure status Rural infra fund to be raised from Rs160 billion to Rs180 billion Modern cold storage now recognised as infrastructure sector FII cap for infra bonds with 5 year residual maturity
Environment	Proposal to set up national mission for hybrid and electric vehicle
Inclusive growth	National Food Security Bill (NFSB) to be introduced in Parliament during this year Allocation for social sector in 2011-2012 increased by 17% to Rs1609 billion over FY11 Allocation for education increased by 24 per cent over current year Rs210 billion for literacy mission Educational sector allocated Rs521 billion in FY12 Social sector expenditure has increased by 17% to Rs1.7 trillion
Others	Goods and Services Tax Constitutional Amendment bill in current session FIIs allowed to invest in domestic Mutual Fund schemes FII investment in corporate bond market hiked by additional US$20 billion to US$40 billion PSU banks capitalization of Rs 60 billion during 2011-2012 to enable them to maintain minimum of Tier I CAR of Rs1 billion equity fund for microfinance companies. Increased priority home loan limit from Rs20 lakhs to Rs25 lakhs 1% interest subvention on home loans upto Rs15 lakhs

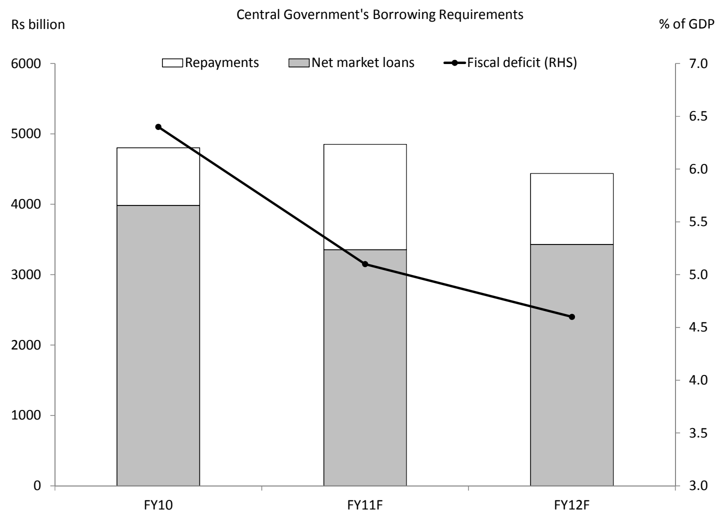
Source: Ministry of Finance, CEIC, GS Global ECS Research.

Exhibit 4: The budget numbers

Central Fiscal Deficit	FY10	FY11(RE)	FY12(BE)
Rs bn			
Revenue receipts	**5728**	**7838**	**7899**
% yoy	*6.0*	*36.8*	*0.8*
Net tax revenue	4565	5637	6645
% yoy	*3.0*	*23.5*	*17.9*
Non tax revenue	1163	2201	1254
% yoy	*20.0*	*89.3*	*-43.0*
Non-debt capital receipts (excluding disinvestment)	**86**	**90**	**150**
Privatization	**246**	**227**	**400**
Gross tax revenue	**6245**	**7869**	**9324**
%yoy	***3.2***	***26.0***	***18.5***
Corporation tax	*2447*	*2964*	*3600*
Income tax	*1323*	*1491*	*1720*
Customs	*833*	*1318*	*1517*
Union Excise duties	*1036*	*1378*	*1641*
Others	*584*	*694*	*820*
Total expenditure	**10245**	**12166**	**12577**
% yoy	*15.9*	*18.8*	*3.4*
Current expenditure	9118	10537	10972
%yoy	*14.9*	*15.6*	*4.1*
Interest payments	*2131*	*2408*	2680
Subsidies			
Food	*560*	*606*	*606*
Fertilizers	*530*	*550*	*500*
Petroleum	*146*	*384*	*236*
NREGA	*391*	*401*	400
Capital expenditure	1127	1629	1606
%yoy	*25.0*	*44.5*	*-1.4*
Fiscal deficit (incl. disinvestment)	4185	4010	4128
Fiscal deficit (excl. disinvestment)	4431	4237	4528
% of GDP	**FY10**	**FY11 (RE)**	**FY12 (BE)**
Revenue receipts	8.7	9.9	8.8
Net tax revenue	7.0	7.2	7.4
Non tax revenue	1.8	2.8	1.4
Capital receipts (includes disinvestment)	0.5	0.4	0.6
Gross tax revenue	9.5	10.0	10.4
Corporation tax	*3.7*	*3.8*	*4.0*
Income tax	*2.0*	*1.9*	*1.9*
Customs	*1.3*	*1.7*	*1.7*
Union Excise duties	*1.6*	*1.7*	*1.8*
Others	*0.9*	*0.9*	*0.9*
Disinvestment	0.4	0.3	0.4
Total expenditure	15.6	15.4	14.0
Current expenditure	13.9	13.4	12.2
Interest payments	*3.3*	*3.1*	*3.0*
Capital expenditure	1.7	2.1	1.8
Fiscal deficit (incl. disinvestment)	**6.4**	**5.1**	**4.6**
Fiscal deficit (excl. disinvestment)	**6.8**	**5.4**	**5.0**
Disinvestment	246	227	400
Net market loans	3984	3354	3430
Repayments	818	1497	1009
Gross market loans	**4802**	**4851**	**4439**
BE: Budget Estimates, RE: Revised Estimates			

Source: Ministry of Finance, CEIC, GS Global ECS Research.

Exhibit 5: The budget expects a decline in central government gross and net borrowing



Source: Ministry of Finance, CEIC, GS Global ECS Research estimates.

Impact on bond yields

The government announced a lower-than-expected market borrowing of Rs3.4 trillion (US$75 billion). However, we think that given the uncertainties about the government's ability to meet its deficit targets, the market borrowing could be higher. Therefore, we do not think the budget will be positive for government bonds.

Impact on the INR

The impact on the INR may be incrementally positive due to the measures taken to ease capital inflows. In particular, the increase in foreign investment limits in corporate bonds, and allowing foreign investors to invest in domestic mutual funds are both welcome easing of the capital account.

Impact on the equity market

We think the impact on the equity market is largely neutral as there is sufficient uncertainty on the fiscal deficit numbers to put them into question. Some of the reform measures—a strict timeline on the direct tax code, the introduction of a direct cash transfer scheme for subsidies, and the awarding of fresh back licenses are all incrementally positive, but other key reforms such as FDI in retail and land acquisition reforms are still pending.

Exhibit 6: Implications of the budget on sectors

Sector	Key recommendation	Impact
(Analyst name)		
Cement *(Pritesh Vinay)*	Change in excise duty structure for grey cement from specific to uniform ad-valorem tax	Neutral - will be passed to final consumer
	Basic customs duty on gypsum and pet coke reduced from 5% to 2.5%	Positive
	Higher budget allocation of Rs2,140 bn for infrastructure, +23% yoy	Positive - could potentially boost cement demand
Metals & Mining	Hike in export duty of iron ore - 20% for fines (currently 5%), 20% for lumps (currently 15%). Iron ore pellets have been exempted from export duty.	Negative for iron ore exporters (Sesa Goa), marginally positive for domestic steel makers
(Pritesh Vinay)		
IT	Increase of MAT from 18% to 18.5%	Mild Negative
(Balaji Prasad)	No extension of the STPI Tax Holiday	Mild Negative
	SEZ units to come under MAT provisions	Mild Negative
Pharma *(Balaji Prasad)*	Increase in healthcare expenditure outlay by 20%	Positive
	Inclusion of healthcare services under service tax net	Mild Negative
	Increase of MAT from 18% to 18.5%	Mild Negative
	SEZ units to come under MAT provisions	Mild Negative
Telcos *(Sachin Salgaonkar)*	Increase in MAT rate by 50 bp to 18.5% (from 18.0%). While this should have a slight negative impact on the earnings of RCOM/Idea, we believe the impact on Bharti's earnings should be relatively lower given its existing higher blended tax rate (due to higher tax rates in its African operations)	Moderately negative
	Rural Telecom and Rural Broadband are included in an overall allocation of Rs580 bn (which includes other rural initiatives) under which the government plans to provide Rural broadband connectivity to all 250,000 Panchayats in three years. While this should help improve the broadband infrastructure in rural areas, we do not view this as material (given the low proportion of telcos' revenues from rural broadband), and believe should be slightly positive for telcos	Slightly positive
	We believe in the Rs296.48 bn which government intends to raise from the telecom sector in terms of recurring license fees and other usage charges includes Rs162.3 bn – amount recommended by TRAI to be raised from incumbents for excess 2G spectrum charge. This is slightly negative for incumbents as it implies that govt would most likely accept the TRAI excess spectrum recommendations	Slightly negative
FMCG *(Aditya Soman)*	Excise taxes for cigarettes unchanged; Income tax surchage reduction to 5% from 7.5% positive	Positive for ITC
Real Estate *(Puneet Jain)*	SEZ Units come under preview of MAT. Impacts DLF (SEZ projects accrue around 12% of NAV) and Prestige Projects (SEZ projects accrue around 13% of NAV)	Negative
	For dwelling units under priority sector lending, loan limit revised to Rs2.5 mn from Rs2 mn	Marginally positive
	Budget mentions investment linked deduction to businesses which develop affordable housing. More details needed for better assessment.	Marginally positive

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

Exhibit 6: Implications of the budget on sectors…continued

Utilities	Increase in MAT to 18.5% from 18% is marginally negative for most of the utilities who are currently under the	Marginally Negative
Fertilizers *(Durga Dath)*	Urea farm gate prices still continue to be regulated as inclusion of Urea under Nutrient based subsidy mechanism is still under consideration.	Marginally Negative
	Classification of fertilizer sector as infra sub-sector should help fertilizer companies fund their existing/future capex programs.	Marginally Positive
Automobiles *(Sandeep Pandya)*	The Budget keeps excise duty unchanged at 10%, vs expectation of 2 pcp increase as part of stimulus reversal that was initiated last year. We believe this is incrementally positive for the sector, particularly given headwinds from higher inflation and commodity costs going into FY2012E.	Positive
Financials	Housing loan amount considered for priority sector loan increased to Rs2.5 mn from Rs2 mn	Marginally positive for housing finance cos.
(Tabassum Inamdar)	Housing loan subsidy of 1% extended to loan amount of Rs1.5 mn, up from Rs1 mn earlier	Marginally positive
	Affirmation of capital infusion in banks (taking government stake up to 58%)	Marginally positive
	Interest subsidy on timely repayment of short-term crop loans up from 2% to 3%.	Marginally positive
Cap Goods *(Ishan Sethi)*	Parallel Excise Duty exemption for domestic suppliers producing capital goods needed for expansion of existing mega or ultra mega power projects.	Positive
	Non-imposition of custom/anti-dumping duty on foreign power equipment makers	Negative
	Cold storage capital goods to be exempt from excise duty	Positive
Infrastructure *(Ishan Sethi)*	Total expenditure allocation of Rs2,14000 cr (US$47.6 bn) – 48.5% of plan expenditure matching the highest allocation previously seen in FY2006. Social Infra schemes (Bharat Nirman) allocation raised 20% to US$12.8bn	Positive
	FII limit to invest in Infra corporate bonds raised to US$40bn; b) Tax-free Infra bonds Rs 30,000cr (US$6.7bn)	Positive
	Withholding tax of 5% on notified infra bonds, vs 20% earlier– encourage more FII investment in infra	Positive
	MAT rate increased from 18% to 18.5% while reducing surcharge from 7.5% to 5% - leading to slight increase in	Negative
	SEZ's also brought under MAT tax net – negative for SEZ developers	Negative
Logistics *(Ishan Sethi)*	Constitution amendment Bill to be introduces in the current session that will pave way for introduction of the GST	Positive
Media (Ishan Sethi)	No change to import duties on set top boxes	Marginally negative
Oil & gas	MAT on units operating in SEZs to impact Reliance Industries. Negative EPS impact of about 4% from FY12 onwards.	Negative
(Nilesh Banerjee)	OMCs might benefit from plans for direct transfer of cash subsidy for kerosene and LPG. Govt. proposes to have a system in place by March 2012. We believe the timeline to be aggressive considering that such a system may be linked to the UID project which will be rolled out over next five years.	Positive
	OMCs may end up with net under recoveries for FY11 of about Rs130 bn or 1/6th of total under recoveries as only Rs.384bn provided in the budget for FY11. For FY12, the budget provides for Rs236bn which may be increased through supplementary grants.	Negative
	Reduction in surcharge on corporate tax from 7.5% to 5% to benefit companies such as GAIL, GSPL, ONGC, Petronet LNG, Oil India as well as the three OMCs.	Positive
	Sunset of tax holiday for certain undertakings engaged in commercial production of mineral oil (Sec 80IB). Deduction not available for blocks licensed under a contract awarded after 31st March, 2011 under the NELP. Will make fresh investments in the sector less attractive	Negative
	ONGC FPO may now be happening in FY2012. We believe this may provide the government with some time to move further on the fuel reforms and get a better realization for its stake.	Neutral

Source: Ministry of Finance, 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.