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Union Budget FY2013: Markets wait for spring cheer in a March budget

The budget would be tabled at a time when growth has slowed down and fiscal targets set in the previous budget, that had looked optimistic at the outset, have been breached

In the run up to Union budget FY2013, the Indian economy continues to present a mixed picture, in the wider context of a tepid global economy. The budget would be tabled at a time when growth has slowed down, albeit with a retreat in inflation. However, fiscal targets set in the previous budget, that had looked optimistic at the outset, have been breached, with April-January FY2012 accounting for 105.4% of the budgeted fiscal deficit. As such, correctives are called for on this front. Indeed, with General elections due in FY2014, there is a small window of opportunity in the FY2013 Budget to take meaningful steps towards fiscal consolidation, and more generally give a direction to policy.

This would be one of the few March budgets and markets would hope that the Finance Minister can spread some cheer

This budget would be one of the few March budgets (to be presented on March 16th as against the usual norm of the last working day of February), which are typically associated in years that had General Elections. The Government has made this year an exception, as it would want to assess its political strength at the Centre. Thus the state election results due on March 6th hold a special significance for this year's budget if the UPA were to muster enough support to undertake some much-needed reforms.

FY2012: A year of fiscal slippages

Our concerns over achieving the ambitious budget deficit target of 4.6% in FY2012, have been founded

In our post FY2012 budget analysis we had expressed our concerns over the ambitious budget deficit target of 4.6% of GDP, given the very optimistic revenue collection target and subsidy estimates, especially on petroleum subsidy (for details refer to our report "Budget FY2012: A fine balancing act" dated February 28, 2011). Moreover, we had also estimated that the Government would have to increase its dependence on market borrowing as it had set very ambitious targets of collections through small saving schemes.

On the revenue front, there was a shortfall on the back of lower collections on corporate, income tax and excise duty due to economic slowdown

What complicates any credible move towards fiscal consolidation is the muted growth environment. With the third quarter GDP for FY2012 witnessing a steep decline and printing 6.1% YoY, the Indian economy is on the brink of registering one of the slowest episodes of growth since the Lehman crisis struck in FY2009. On the revenue front, the Government had budgeted a tax revenue growth of 17.8% and we expect the actual growth to be lower at 15.5%. This big shortfall is on the back of lower collections on corporate, income tax and excise duty due to economic slowdown. The total tax collection is also lower due to reduction in customs and excise duties on crude and petroleum products in June 2011.

On the expenditure front, the targets were missed due to lower budgeting of subsidies coupled with increase in under recoveries and higher import prices of fertilizers

On the expenditure front, the targets were missed due to lower budgeting of subsidies coupled with increase in under recoveries due to rise in oil prices and weaker Rupee and higher import prices of fertilizers.

(in INR bn)	Budgeted estimates	Fiscal year till date	% of actuals to budget estimates	
			Current	Previous
Revenue Receipts	7899	5491	69.5	85.6
of which: Tax Revenue (Net)	*6645*	*4586*	*69.0*	*73.2*
Non-Tax Revenue	*1254*	*906*	*72.2*	*130.4*
Non-debt Capital Receipts	550	180	32.7	71.9
Total Receipts	8449	5671	67.1	90.9
Non-Plan Expenditure	8162	7081	86.8	83.0
Plan Expenditure	4415	2940	66.6	73.1
Total Expenditure	12577	10020	79.7	79.7
Fiscal Deficit	4128	4349	105.4	58.3
Revenue Deficit	3073	3344	108.8	56.3
Primary Deficit	1448	2299	158.7	38.0

Some of the Government's revenue losses would be offset by increased dividend payouts by PSUs

The Government would also most likely miss the INR 140 bn revenue, which it had expected to raise via spectrum auctions. Some of these revenue losses would be offset by dividends from state owned enterprises as the Government has asked cash rich PSUs to increase the dividend payout ratio. Media reports suggest that some companies have agreed to higher dividend payment, which would result in an INR 60 bn inflow to the exchequer. Overall, we estimate the additional revenue through dividend payments to be to the tune of INR 100 bn.

Assuming some roll over of fuel subsidy along with measures like buy back of Government stake by cash rich PSUs and disinvestment proceeds, the headline fiscal deficit number is expected to be around 5.7% of GDP

Assuming some roll over of fuel subsidy (postponement of oil subsidy payment of around INR 300 bn and some on the fertilizer subsidy), as was done last year along with some measures like buy back of Government stake by cash rich PSUs and disinvestment proceeds (ONGC), the headline fiscal deficit number is expected to be around 5.7% of GDP, as against 4.7% in FY2011.

The General Government fiscal (Center and State combined) is likely to rise to 8.7% of GDP in FY2012 from 7.3% in FY2011. The significant rise in the deficit number is also due to absence of one off revenue like telecom auctions (which contributed to around 1.3% of GDP) and disinvestments.

The crux of the Union Budget FY2013 will be fiscal consolidation, with the mix of revenue and expenditure measures crucial in determining the extent of consolidation

Perspectives for FY2013: A year of consolidation

The crux of the Union Budget FY2013 will be fiscal consolidation, keeping in mind the need to support the faltering growth momentum. The mix of revenue and expenditure measures would be crucial in determining the extent of fiscal consolidation.

Revenue

Tax revenue

On the tax front, we expect the Government to introduce certain changes in the indirect tax structure that are in line with the introduction of GST, although it is unlikely to be implemented in totality in FY2013

On the tax front, we expect the Government to introduce certain changes in the indirect tax structure that are in line with the introduction of goods and service tax (GST), although it is unlikely to be implemented in totality in FY2013. The key revenue generating measures likely to be announced are roll back of tax cuts to pre 2008 level and increasing the list of goods and services, which are taxed.

- Increase in excise duties from 10% to 12%
- Increase in service tax from 10% to 12%
- Increasing the excise tax base by lowering the exemption limit
- There is a possibility that the Government comes out with a negative list on service tax, wherein all services except those mentioned in the list are taxed. The Empowered Committee of State Finance Ministers have recently

agreed to such a measure in order to enable broad based coverage

- These increases in taxes are likely to result in additional INR 300 – 400 bn inflow to the exchequer

DTC is unlikely to be implemented in FY2013, although increase in tax slabs would be a step in the right direction

With regards to the implementation of the direct tax code (DTC), the Government has yet again missed its deadline, which was April 2012 and this is unlikely to be announced this year as it is still under consideration with the Standing Finance Committee. However, we expect this year's budget to give further relief to the common man with regards to their disposable income as the tax slabs are expected to be increased, in a move that takes us closer to DTC. Under the proposed tax structure, an individual earning above INR 10 lakh will save upto INR 22,000 annually.

Income bracket		Tax (%)
Current	Proposed	
Less than INR 1.8 lakh	Less than INR 2.0 lakh	Nil
Between INR 1.8 - 5.0 lakh	Between INR 2.0 - 5.0 lakh	10
Between INR 5 - 8 lakh	Between INR 5 - 10 lakh	20
Above INR 8 lakh	Above INR 10 lakh	30

There could be announcements to curtail benefits through tax havens or measures to bring back unaccounted money through the announcement of one-off amnesty schemes or mandatory declaration of overseas assets

Additionally, there could be announcements to curtail benefits through tax havens or measures to bring back unaccounted money through the announcement of one-off amnesty schemes (the introduction of such a Voluntary Disclosure of Income Scheme in 1997 had resulted in INR 105 bn of revenue for the exchequer) or mandatory declaration of overseas assets.

Some of the revenue lost due to increase in income tax slabs would be offset by increases in indirect tax as the proportion of the latter is much higher than that of direct tax

Some of the revenue lost due to increase in income tax slabs would be offset by increases in indirect tax, as the proportion of the latter is much higher than that of direct tax. Despite slowdown in exports, demand for tax incentives is unlikely to be met, given the priority to bridge the fiscal gap. Reduction in Securities Transaction Tax on equity trade is likely in order to boost the depth of the capital market. Overall, we expect the tax revenue to GDP ratio to increase to 7.6% of GDP from estimated 7.3% in FY2012 on the back of improved growth prospects.

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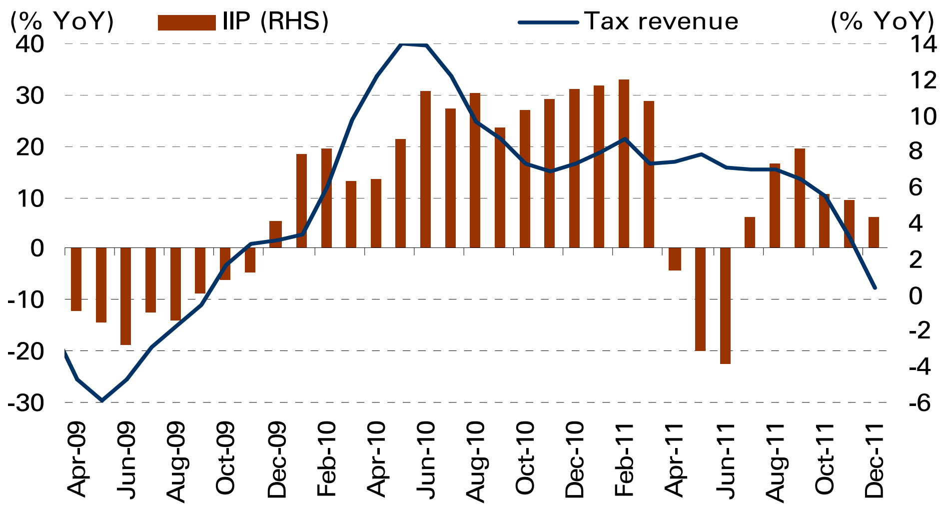
Co-movement between industrial production and tax revenue



Non-tax revenue

The Government is likely to continue to rely on non-tax revenue to aid fiscal consolidation. On the disinvestment front, the Government is likely to budget

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On the disinvestment front, the Government is likely to budget INR 400 bn but would be able to garner only INR 250 -350 bn, contingent on market conditions

INR 400 bn but would be able to garner only INR 250 -350 bn, contingent on market conditions. In FY2013, apart from using the IPO route, the Government is also likely to auction it's stakes in PSUs to institutional investors only (similar to the recently concluded ONGC stake sale), which is possible given the recent regulatory changes. Also, the Government is in the process of finalizing the creation of a special purpose vehicle (SPV), which would buy stakes in Government owned companies. The Government holds stakes in ITC, Axis Bank and L&T through Specified Undertaking of Unit Trust of India (SUUTI), which it will sell to the SPV, which in turn will leverage it and take loans from banks to participate in the disinvestment program. Additionally, auctioning of new coal blocks could be another way of raising non-tax revenue.

Companies identified for Disinvestments	Current Govt. Holding (%)
SAIL	86
NMDC Ltd.	90
ONGC Ltd.	69
NTPC Ltd.	85
Coal India Ltd.	90
Oil India Ltd.	78
MMTC Ltd.	99
Neyvile Lignite Corp. Ltd.	94
NHPC Ltd.	86

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Expenditure

It is imperative for the Government to increase the tax to GDP ratio to sustain lower fiscal deficit, as most of our expenditure is sticky, thereby leaving the Government with limited room to reduce that component. To put this in perspective, if we look at the expenditure breakup of FY2012, around 50% of the total expenditure was on interest payments, subsidies and defence, another 20% on salaries of public sector employees, thereby leaving only around 30% to be the discretionary component.

On the expenditure front, the Government will have to slash the bloated subsidy bill, especially fuel subsidy, as going forward food subsidy bill is going to increase further

On the expenditure front, the Government will have to slash the bloated subsidy bill, especially fuel subsidy. The food security bill will add to pressures on the fiscal. However, the impact of the bill is likely to be much lower than the estimated INR 1 tn as the Government will still require a couple of more months to get the requisite approval on food security bill. Additionally, the project will be implemented on a pilot basis this year and therefore the cost to the Government will be lower.

With regards to India's heavy fuel subsidy bill, deregulation of petroleum prices did bring relief to the oil companies last year but the OMCs continue to still post huge losses due to under recoveries on account of diesel and LPG. Recently, Deputy Chairman of Planning Commission, Montek Singh Ahluwalia pointed out that unlike food and fertilizer subsidy, diesel subsidies are uncapped.

Given the upward pressure on crude prices, it will be important not to under budget crude prices in FY2013 as was the case in FY2012

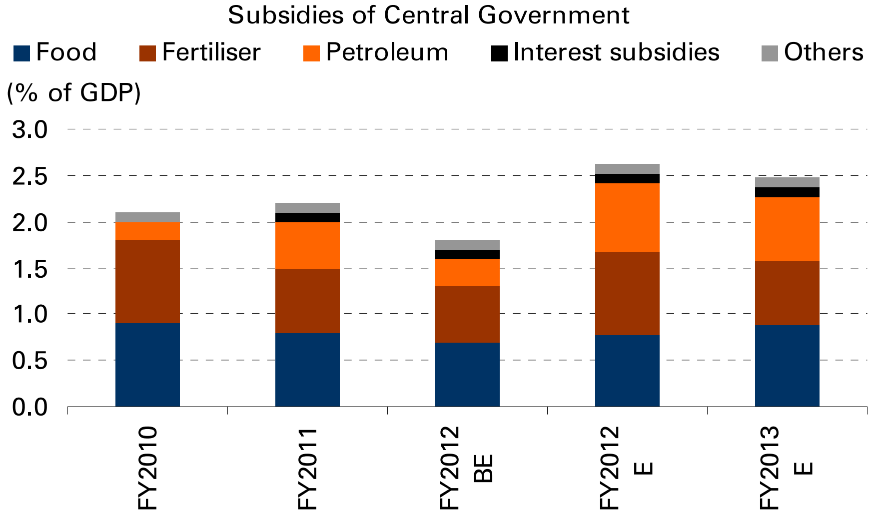
With the current level of crude prices, under recoveries are likely to be high, which would further weigh on the exchequer. Given the upward pressure on crude prices, it will be important not to under budget crude prices in FY2013 as was the case in FY2012, which tends to distort the fiscal calculations. We expect Brent crude to be around USD 120-125 per barrel in FY2013 as against

USD 110-115 per barrel during FY2012, while the budgeted was USD 90/ barrel.

The Government has room to increase the retail prices of diesel, LPG and Kerosene this year before it heads into a populist mode in the next budget ahead of the General elections in FY2014

However, the Government has room to increase the retail prices of diesel, LPG and Kerosene this year before it heads into a populist mode in the next budget ahead of the General elections in FY2014. We expect around 10% increase in diesel, LPG and kerosene price as early as July to take advantage of the high base effect due to last year's increase in diesel price. Further, easing inflationary pressure gives additional scope to increase fuel prices. On the fertilizer front, news report recently indicated that the Government is likely to cut by a fifth the subsidy it gives to phosphate and potash-based fertilizers in FY2013. Additionally, there are talks of decontrolling of Urea prices, even if that happens to some extent, it would significantly lower the fertilizer subsidy bill.

On the fertilizer front, news reports recently indicated that the Government is likely to cut the subsidy given to phosphate and potash-based fertilizers and decontrol urea prices in FY2013



The Government might need to extend capital to state run banks for bank recapitalization and provide for additional revenues to State Governments for debt restructuring of state electricity boards

There could be additional expenditures as the Central Government might need to extend capital to state run banks for bank recapitalization and provide for additional revenues to State Governments for debt restructuring of state electricity boards (SEBs). According to media reports, the SEBs have already accumulated bank debt of INR 1.8 tn (due to subsidised electricity distribution), they are finding it to difficult to raise further debt and thus we expect the Government to support them via an interest rate subsidy.

There could be some reclassification of what constitutes plan and non-plan expenditure. Media reports suggest that the Government is contemplating expanding the plan category by ten items in FY2013 after increasing four items in the last budget. There could also be reduction in the number of centrally sponsored schemes (to avoid overlap between different schemes), in line with B K Chaturvedi Committee, which recommends reduction of such schemes to 59 from current 147.

We would want the Government to increase the share of capital expenditure, especially on infrastructure projects

While the wish list from the budget is rather long, some of the key issues that need to be addressed in the upcoming budget are:

- Increase the share of capital expenditure, especially on infrastructure projects as insufficient allocation for such projects acts as a drag on growth
- Roadmap for GST and DTC
- Announce the time line for multi-brand FDI to restore investor confidence
- Focus on removing supply side bottlenecks particularly in the power sector and increase public investment in the same
- Extend further clarity on the UID project
- Announce roadmap for direct cash transfer for subsidies (an idea that was proposed in the last budget), which will help in curbing systemic leakages

Focus on removing supply side bottlenecks particularly in the power sector and increase public investment in the same

According to the Thirteenth Finance Commission Report, which aims at fiscal consolidation, fiscal deficit was to be brought down to 4.2% of GDP by FY2013

The Central Government will clearly miss this target but its efforts towards fiscal consolidation will help the deficit to ease to around 5.1% of GDP in FY2013

We expect net issuance of around INR 5.0 tn in the next fiscal. Additionally, state government borrowing is likely to be around INR 1.2 tn, thus aggregate supply is estimated at INR 6.2 tn

The risks to our view emanate from surge in crude oil prices, which will weigh on both fuel and fertilizer subsidy bill and uncertainty over food prices

Lastly, the Government needs to focus on the quality of fiscal consolidation

(as % of GDP)	FY2012 BE	FY2012 E	FY2013 E
Revenue Receipts	8.9	8.6	8.9
of which: Tax Revenue (net to centre)	*7.5*	*7.3*	*7.6*
Non-Tax Revenue	*1.4*	*1.3*	*1.3*
Capital Receipts	0.6	0.4	0.4
of which: Recoveries of Loans	*0.2*	*0.2*	*0.1*
Other Receipts	*0.4*	*0.2*	*0.3*
Total Receipts	14.1	9.0	9.3
Non-Plan Expenditure	9.2	10.0	9.8
On Revenue Account of which:	*8.2*	*9.1*	*8.8*
Interest Payments	*3*	*3.0*	*3.0*
Subsidies	*1.6*	*2.6*	*2.5*
Defense	*1.1*	*1.1*	*1.1*
On Capital Account	0.9	0.9	1.0
Plan Expenditure	5.0	4.7	4.6
On Revenue Account	4.1	3.8	3.8
On Capital Account	0.9	0.9	0.8
Total Expenditure	14.2	14.7	14.4
Revenue Deficit	3.4	4.3	3.7
Fiscal Deficit	4.7	5.7	5.1
Primary Deficit	1.7	2.7	2.1

GDP FY2012 assumed to be INR 89.12 tn as against budgeted INR 89.81 tn. Nominal growth for FY2013 is estimated to be 14%

Fiscal deficit expected at 5.1% in FY2013

According to the Thirteenth Finance Commission Report, which aims at fiscal consolidation, fiscal deficit was to be brought down to 4.2% of GDP by FY2013. While this target is well beyond reach, the Government will try to narrow the fiscal gap in its effort to attract foreign investors. Overall, we expect fiscal deficit to GDP ratio to ease to 5.1% of GDP in FY2013 from 5.7% of GDP in FY2012. However, there is a possibility that the Government presents a more optimistic budget with fiscal deficit projection of under 5% of GDP. But that might not be a reason to cheer as we could see a repeat of FY2012 when the target was revised upward during the latter half of the year.

Under our base case scenario, we expect the fiscal deficit to be around 5.1% of GDP in FY2013, which would result in net issuance of around INR 5.0 tn. Additionally, state government borrowing is likely to be around INR 1.2 tn, thus aggregate supply is estimated at INR 6.2 tn. We expect a slight pick up in other sources of capital receipts like State Provident Fund following the recent increase in provident fund interest rates.

The risks to our view emanate from surge in crude oil prices, which will weigh on both fuel and fertilizer subsidy bill and uncertainty over food prices, depending on the monsoon. However, higher than expected disinvestment proceeds and an earlier than expected rise in retail prices of diesel and LPG could surprise us on the positive side, thereby facilitating a lower fiscal deficit.

Lastly, on a medium to long-term perspective, the Government needs to focus on the quality of fiscal consolidation. Our analysis shows that raising tax revenues (as a share of total public revenues) increases the efficacy of consolidation. This reflects the contribution of more stable revenue sources to the budget. This is in contrast to non-tax revenue that constitutes only one off accretion to receipts and dependence on this mode should be reduced ideally. Along with this, reduced transfer payments substantially increases the probability of debt reduction going ahead. Increase in public investment has short-term consequences for deficit but over the long term it helps to stabilise the system, as these measures are essentially pro-growth.

Annexure I

Fiscal snapshot				
(in INR bn)	FY2012 BE	FY2012 E	FY2013 E	(% YoY)
Revenue Receipts	7899	7664	9042	18.0
of which: Tax Revenue (net to centre)	*6645*	6506	7722	18.7
Non-Tax Revenue	*1254*	1159	1321	14.0
Total Receipts	8449	8021	9449	17.8
Non-Plan Expenditure	8162	8912	9957	11.7
Plan Expenditure	4415	4189	4674	11.6
Total Expenditure	12577	13101	14630	11.7

Annexure II

Revenue receipts consists of tax revenues and other revenues. Tax revenues consist of proceeds from tax and duties levied. Other receipts are made up of interest and dividend payment and receipts for services rendered by the Government.

Revenue expenditure consists of wages and salaries, interest payments, subsidies and normal functioning of various ministries. This can more or less be classified as expenditure, which does not result in asset creation for Government of India.

Capital receipts consist of loans raised by the Government from the public, otherwise know as market borrowing, borrowing from the RBI, loans from foreign governments and other multilateral bodies and recoveries of loans. Recently, disinvestment by the Government has also started to contribute significantly to capital receipts.

Capital expenditure mainly consists of acquisitions such as land, machinery, equipment and investments in various financial instruments.

Government expenditure is classified under two heads viz. plan and non-plan.
Plan expenditure arises out of schemes freshly introduced in an ongoing Five-Year Plan (FYP) period. In the same period, non-plan expenditure arises out of schemes carried forward from previous FYP periods.
Non-Plan expenditure, therefore, supports the old schemes of governments and plan expenditure, the new schemes. Since new schemes add to the economy's productive capacity as the old schemes did in the past, plan expenditure reflects government's investment in enhancing the economy's productive capacity. Thus non-plan expenditure maintains the existing capacities and plan expenditure adds to it.

Fiscal deficit is defined as total expenditure less revenue receipts, recoveries of loans and other receipts. Total expenditure is the sum of plan and non-plan expenditure.

Primary deficit is defined as fiscal deficit net of interest payments.

(Source: Budget documents and Planning Commission)

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