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India Economics

What Do We Expect from Budget F2013?

Two important issues we are watching for in Budget F2013: The government is scheduled to present the annual budget F2013 on March 16. Considering the current weak macro trend, investors are building hope that the government will recognize the need to relay its commitment to reviving the growth outlook with budget measures. We would watch the budget announcement in the context of two most important issues:

- A credible plan to cut government expenditure growth
- Policy measures to encourage private investment

Market implications: According to our India Strategist, Ridham Desai, "history does not favor the market in the following 3-4 weeks. The markets are usually flat in the month ahead of the budget and, in two out of three years, fall in the month following it. In the past 15 years, the market has been positive in the following years: 1997, 1999, 2004, 2006, 2009, 2010 and 2011 – there does not seem to be a great correlation between market performance and a market-friendly budget. We continue to be buyers of Indian equities from a 12- to 18-month perspective, though seek protection from a correction in the near term."

Industry-specific expectations: Our analyst team expects the budget to be a clear positive for infrastructure and utilities. We do not see any policy measures that hurt consumption, but we believe any credible plan to reduce government revenue expenditure growth or oil subsidies will hamper the top lines of some consumer industries in the near term.

For important disclosures, refer to the Disclosures Section, located at the end of this report.

What Do We Expect From Budget F2013?

Summary

The government is scheduled to present the annual budget F2013 on March 16. Considering the current weak macro trend, investors are building hope that the government will recognizing the need to relay its commitment to reviving the growth outlook with budget measures. We would watch the budget announcement in the context of two most important issues:

- *A credible plan to cut government expenditure growth*
- *Policy measures to encourage private investment*

Particularly on expenditure growth target, we believe the implementation of the promise in the budget is more important than the promise itself. For instance, for F2012, the government budget announcement for projected fiscal deficit was 4.6% of GDP – but the actual trend for April-Dec indicates that the deficit will likely be at 6-6.2% of GDP. Including off-budget subsidies, the deficit will be 6.9-7.1% of GDP.

Exhibit 1

Fiscal Deficit Consolidation Is Critical Now

As % of GDP	F2008	F2009	F2010	F2011E	F2012E
Central Fiscal Deficit	2.5%	6.0%	6.5%	4.8%	6.0%
State Fiscal Deficit	1.5%	2.4%	3.3%	2.6%	2.5%
Sub-total	**4.1%**	**8.4%**	**9.8%**	**7.4%**	**8.5%**
Inter-government adjustments	-0.1%	-0.1%	-0.1%	0.0%	0.0%
Combined Headline Deficit	**4.0%**	**8.3%**	**9.7%**	**7.4%**	**8.5%**
Major Off-budget expenditure items	0.8%	1.6%	0.2%	0.6%	0.9%
Overall Fiscal Deficit	**4.8%**	**9.9%**	**10.0%**	**8.1%**	**9.4%**
Overall Fiscal Deficit (excluding 3G receipts)	*NA*	*NA*	*NA*	*9.4%*	*9.6%*

Source: Budget Documents, Morgan Stanley Research, E=Morgan Stanley Research Estimates

Macro Backdrop Calls for Clear Commitment in the Budget

The macro environment in India has been challenging over the last few months. Though the global funding environment has improved recently, we have been arguing that domestic factors are still holding back a V-shaped recovery. At the heart of the poor macro environment in India has been the bad mix of growth since the credit crisis unfolded in 2008. The ratio of private investment to GDP has been declining, yet the government deficit has prevailed in the range of 9-10% of GDP (excluding one-off revenues from telecom license fees). This divergent trend in private investment and fiscal deficit has been steadily taking down India's potential growth over the last four years. Policymakers' attempt to push for higher growth with this bad mix has brought the feedback of higher inflation, current account deficit and tighter inter-bank liquidity.

Need to Get the Productivity Dynamic Back

In this context, we believe that the government will need to focus on reviving the productivity dynamic and bring back the private investment gradually to lift the sustainable growth. As we have been highlighting, we believe that the revival in investment cycle is the key to recovery in overall growth in this cycle.

Any measure that aims to push consumption will cause inflation to remain higher for longer and increase the risk of hard landing in the economy. In India, the sharp decline in private corporate investment after the credit crisis has meant that the sustainable GDP growth rate at which inflation is non-accelerating has also declined. As we have seen over the past two years, boosting consumption and intervention in the rural labor market through employment scheme in this environment has brought high and persistent inflation. Inflation has been now above the RBI's comfort zone of 5-5.5% for over two years now. A further boost to domestic consumption through monetary and fiscal easing in the face of capacity constraints and already high inflation would only intensify the inflation problem. Hence, the government needs to push private investment to revive growth this time.

However, the current macro environment is discouraging for entrepreneurs. Reviving capex in a counter-cyclical manner will need aggressive policy effort. Assuming that the political environment improves after the assembly elections in Uttar Pradesh, the government could initiate some of the long-pending policy reforms, such as allowing FDI in multi-brand retail and reduction of fuel subsidies, along with the budget announcement or around that time. Recently, the government has started taking actions to address the long-pending issues of supply of fuel for electricity projects. This could be a good start – but a sustained effort will be critical to revive private investment in a counter-cyclical manner.

As we have been highlighting, there is a need to accelerate implementation of major policy reforms:

- Enacting the *Goods and Services Tax Act* – GST (value added tax).
- *Strengthening institutional capacity to manage the awarding of major infrastructure projects* through public-private route, which should increase transparency;
- Building a *comprehensive plan for energy security* along with a systematic program for energy pricing reform;
- Meaningful steps towards *divestment of the government's stakes in SOEs*
- *Acceleration in infrastructure spending*, particularly for power: The government needs to systematically address institutional capacity to sustain a steady rise in infrastructure spending.

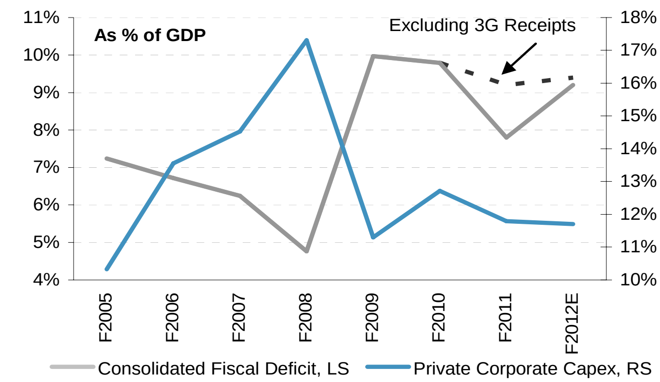
The government could potentially announce its commitment on to initiate the above mentioned policy reforms – but as always, implementation is more important. We believe that this process of implementing policy reforms that revives investment will be time-consuming considering Indian political and current institutional structure.

Simultaneously, it will be critical to reduce the fiscal deficit with the support of a significant cut in government expenditure growth to low single digit levels. Strong expenditure growth and higher subsidies – at a time when tax revenue growth has been slowing – has kept central government deficit high (including off-budget subsidy in the range of 6.9-7.1% of GDP). This boost to consumption via public spending had helped to offset the shortfall in growth from the decline in private investment to GDP to some extent. However, without an accompanying rise in new productive capacity, it also aggravated the inflation pressures from higher global commodity prices.

In addition, we believe that there is a need to reconsider the unproductive dynamics of the Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA), which has boosted rural wages but without a significant improvement in farm output. Although this program had the right policy intentions, its implementation has caused major distortions in the economy, in our view.

Exhibit 2

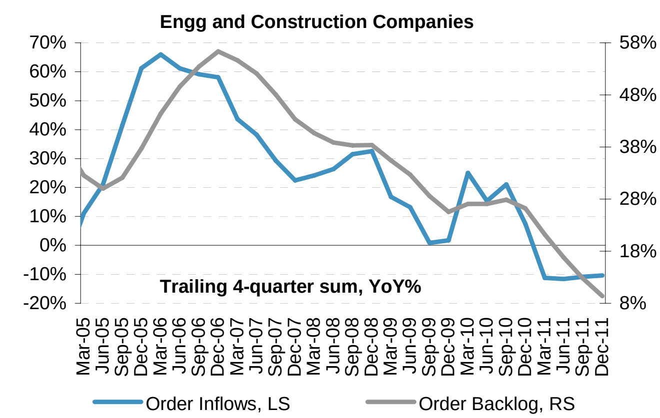
Fiscal Deficit vs. Private Corporate Capex (as % of GDP) – Time to Change This Bad Mix of Growth



Source: CSO, Budget Documents, RBI, E=Morgan Stanley Research Estimate

Exhibit 3

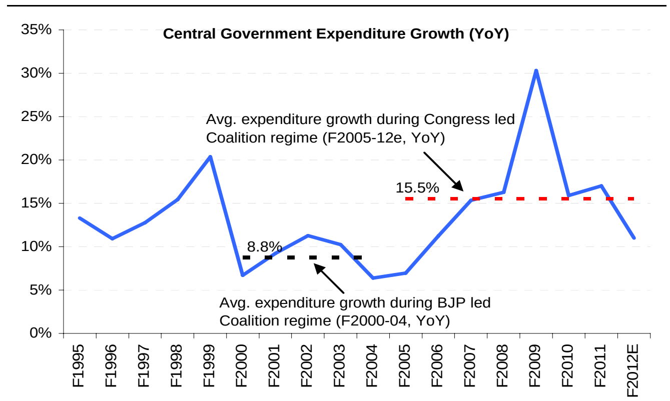
Private Sector Confidence in Capex Is Low: Engineering/Construction Order Inflows (YoY%)



Source: Company data, Morgan Stanley Capital Goods Team – Akshay Soni and Pratima Swaminathan

Exhibit 3

Critical to Reduce Expenditure Growth



Source: Budget Documents, E= Morgan Stanley Research Estimates

What Kind of Fiscal Consolidation Is Needed?

We believe the government is likely to project reduction in the fiscal deficit partly by cutting expenditure growth and partly by increasing tax rates. We believe the government will be targeting a fiscal deficit of 4.9% (5.7% of GDP including off-budget subsidy of 0.8% of GDP) compared with 6% estimated for F2012 (6.9% of GDP including off-budget subsidy of 0.9%). We expect the government to announce increase in excise duty and services taxes by expansion of a number of items which are taxed and increase in duties on certain products

We do see some risk that the government may resort to 1-2ppt increases in excise and services tax rates across the board. In our base case, however, we are assuming that the government will likely avoid increasing excise duties and service taxes across the board, considering the statement made by the finance minister in last year's budget on this subject:

"In view of the healthy growth in indirect taxes in 2010-11, I had the option to roll back the Central excise duty to levels prevailing in November 2008. I have chosen not to do so for two reasons. I would like to see improved business margins translated into higher investment rates. I would also like to stay my course towards GST. I have therefore decided to maintain the standard rate of Central excise duty at 10 per cent."

We believe the bigger contributor to reduction in projected deficit will be a cut in the ratio of government expenditure to GDP. We expect the government to target a lower expenditure growth rate of 7.5-8% compared with estimated growth of 11% in F2012 (note April-December growth has been 13.9%). Moreover, we expect the government to make an announcement on the medium-term plan on aim to reduce non-merit subsidy spending and leakage in welfare scheme spending as enrolling of unique identification numbers is scaled up by the Unique Identification Authority of India (UIDAI).

We believe the current macro backdrop warrants a reduction in fiscal deficit with the support of reduction in expenditure and subsidies – and not by increase in taxes. Hiking taxes may help bring credibility to the government's intention to reduce market borrowings, but we think it would be a less appropriate move – especially at a time when private investment sentiment is weak. Reduction in expenditure will also be critical to ensure that any revival in private investment is accommodated without increasing the aggregate demand pressures and inflation risks.

Exhibit 4

Expenditure Growth: Promise vs. Performance

	Total Expenditure Growth (YoY)		
	Budgeted	Actual	Divergence - Actual vs. Budgeted
F2005	0.8%	7.0%	6.2%
F2006	1.7%	11.3%	9.6%
F2007	10.9%	15.4%	4.5%
F2008	17.0%	16.3%	-0.7%
F2009	5.9%	30.3%	24.4%
F2010	13.3%	15.9%	2.6%
F2011	8.5%	17.0%	8.5%
F2012	3.4%	13.9%*	10.5%

Source: Budget Documents, Morgan Stanley Research * Apr-Dec 2011 actual

Exhibit 5

Main Components of Revenue Expenditure

	As % of Total Revenue Exp.			
	Defense Exp	**Interest Payments**	**Subsidies**	**Other Exp**
F2007	10.0%	29.2%	11.1%	49.7%
F2008	9.1%	28.8%	11.9%	50.2%
F2009	9.2%	24.2%	16.3%	50.2%
F2010	9.9%	23.4%	15.5%	51.2%
F2011RE	8.6%	22.8%	15.6%	53.0%
F2012E	8.3%	23.6%	16.5%	51.6%

Source: Budget Documents, Morgan Stanley Research, E=Morgan Stanley Research Estimates

Exhibit 6

Key Levers to Reduce Fiscal Deficit in F2013

Key Levers for Fiscal Deficit	Sensitivity
Excise Duty	A 5% increase in growth reduces fiscal deficit to GDP by ~5bps
Custom Duty	A 5% increase in growth reduces fiscal deficit to GDP by ~5bps
Service Tax	A 5% increase in growth reduces fiscal deficit to GDP by ~3bps
Divestments	Every INR50bn of additional divestment reduces fiscal deficit to GDP by ~5bps
Expenditure	A 2% increase in growth increases fiscal deficit to GDP by 25bps
Oil Subsidy	*Every 10% increase in oil price increases oil subsidy burden by US$ 6.5bn or 0.3% of GDP*
Telecom revenue (Excess spectrum & 2G auctions)	*If the premium paid for the 2G license auction is higher than our base case there could be an upside of 0.1-0.5% of GDP in non tax revenue collection*

Source: Morgan Stanley Research

Moreover, we believe that reduction in fiscal deficit should largely be targeted through reducing revenue expenditure, which would to help improve gross national saving. Along with increase in investment, the government needs to aim to increase savings to ensure the current account deficit does not widen from the current level of ~3.3% of GDP (our estimate for F2012). As we have highlighted earlier, (see*: India Economics: Asia Insight: It's Time to Address the Fiscal Deficit Problem*), government expenditure tends to be biased on revenue spending. Within the revenue account, subsidy and interest payments account for nearly 38-40% of expenditure.

The key will be follow-through on the budget announcement with implementation. The implementation of the promise to reduce expenditure will be reflected in the monthly government expenditure data, which we watch closely. Currently, we believe that while the government will target the deficit for F2013 at 4.9%, the actual outcome will depend on its ability to meet the expenditure growth target. So far in the last eight years of United Progressive Alliance (Congress Party-led coalition) rule, this happened only once, in F2008. The government targeted slightly high 17% growth in total expenditure and the actual outcome was 16.3%.

Stock Market Implications

According to our India Strategist, Ridham Desai, "history does not favor the market in the following 3-4 weeks. The markets are usually flat in the month ahead of the budget and, in two out of three years, fall in the month following it. In the past 15 years, the market has been positive in the following years: 1997, 1999, 2004, 2006, 2009, 2010 and 2011 – there does not seem to be a great correlation between market performance and a market-friendly budget. We continue to be buyers of Indian equities from a 12- to 18-month perspective, though seek protection from a correction in the near term."

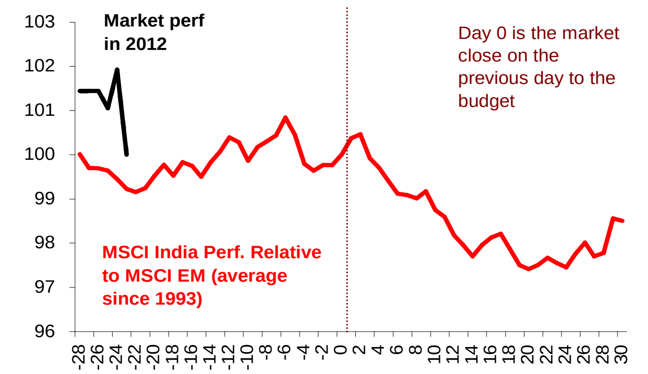
Industry-Specific Expectations

Our analyst team expects the budget to be a clear positive for infrastructure and utilities. We do not see any direct policy measures that hurt consumption, but we believe any credible plan to reduce government expenditure growth or oil subsidies will hamper the top lines of some consumer industries in the near term.

For a quick summary of potential industry-specific measures that could be announced in the budget, please see the table following on page 6.

Exhibit 7

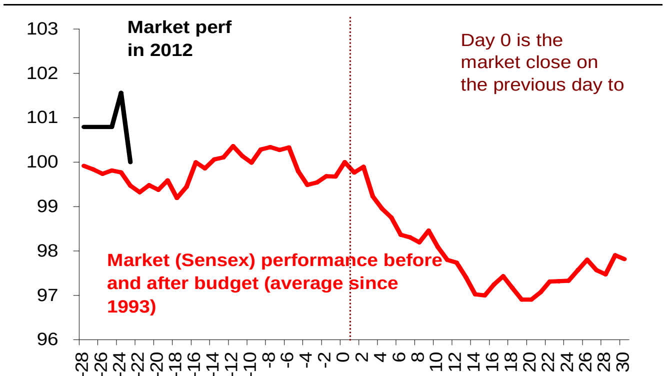
Relative Post-Budget Underperformance



Source: FactSet, Morgan Stanley Research

Exhibit 8

Markets Tends to Fall after the Budget



Source: FactSet, Morgan Stanley Research

We acknowledge the contribution of Yashesh Mukhi to this report.

Exhibit 9

Bottom-Up Industry-Specific Expectations from our Analyst Team

Industry	Budget Expectations
Autos and Autos Parts *Binay Singh*	• We expect no hike in excise duty. Historically, excise duty hikes have happened during times of robust auto growth but given moderate sales across segments, we don't expect any excise hike this time. • We expect additional Rs25,000 duty on diesel cars and UVs. While the petroleum ministry is pushing for additional duty of Rs80k on diesel cars and UVs, we expect a hike of only Rs25k and it could trend up in the coming years in case diesel decontrol does not happen.
Banks *Anil Agarwal & Mihir Sheth*	We would watch for • Any details on potential capital infusion in to state-owned banks • Potential reduction in the lock-in period of term deposits to be eligible for tax deduction from 5 years to 3 years • Any indication on the quantum of funds to be mobilized under RIDF • Any policy initiatives affecting infrastructure projects
Cement *Ashish Jain*	• We do not expect any industry-specific changes. The outlook on infrastructure spending and any import duty changes, if any, on coal, pet coke, gypsum is important.
Construction and Infrastructure Devt. *Akshay Soni*	• We expect a pickup in spending across various segments of Indian infrastructure – Ports, Roads, Airports, Rail and Urban Infra. • We expect that the budget will levy import duties on Power Equipment at 10-12% following demands from domestic power equipment companies like L&T, BHEL etc for a level-playing field. • We expect that the budget will increase the tax exemption limit under Sec 80 CCF for infrastructure bonds from current Rs 20,000 to Rs.1,00,000 to address funding constraints. • Given the coal shortage in the country, we expect that the current 5% import duty on coal may be abolished to reduce the cost of imported coal.
FMCG *Nillai Shah*	• No major changes expected. For cigarettes, we expect a ~10% hike in excise duty. This would be moderate and in line with market estimates as well. If the government harmonises rates of tax on tobacco products & products made with tobacco substitutes, this would be a positive.
Healthcare *Sameer Baisiwala*	• The Budget usually does not have much impact on the healthcare sector. We expect the 200% weighted deduction for R&D spending to continue. Other measures including changes in indirect taxes, budgetary allocation to public healthcare etc. may have a marginal impact.
IT Services *Vipin Khare*	• We expect clarity on implementation schedule for Direct Tax Code which would be applicable to companies. • As per media reports, industry body NASSCOM's wish list is removal of MAT on SEZ units. During last budget MAT was imposed on SEZ units. We do not expect any material change to the current tax structures we believe lowering of MAT rates could be beneficial for companies in our industry. • In the past, there has been news around tax claims by the Income tax department from IT companies on their onsite portion of revenues. A clarification around definitions and applicability of taxes could be helpful for the companies
Media *Vipul Prasad*	• We expect that there could be a possible reduction in import duty for set top boxes to 0%
Metals and mining *Vipul Prasad*	• We expect that there could be a possible reduction in import duty of thermal coal to 0%
Oil and Gas *Vinay Jaising*	• The subsidy bill for the country is expected to remain high at ~US$27bn for FY-12. Given the high subsidy bill, we think the government may look to manage the subsidy bill on the demand side by increasing duties on diesel vehicles • Despite the cut in custom duties and excise duties, which were announced in June 2011, the taxation component remains high in consumer prices (over 45% in petrol and ~24% in diesel). We think there is always a possibility for the government to rationalize these duties. However, given the tight fiscal situation we do not think this to be a high probability event during the budget. • We think government can announce modest price increases in diesel, LPG and kerosene after the election results in March.
Property *Sameer Baisiwala*	• Otherwise a non event for the property group, the government may (i) impose new measures (taxes) to discipline property prices (such as service tax for residential units introduced 2 years back) (ii) thrust on infrastructure would be a longer term demand driver and positive for the market (iii) incentives for mortgages (such as raising the Rs1.5 million deductions for interest payment on home loans) would support ongoing recovery (iv) relaxation of liquidity – lower FDI restrictions and facilitation of foreign borrowings will help companies overcome balance sheet issues
Retailing *Nillai Shah*	• We do not expect any major changes.
Telecom *Vinay Jaising*	• We think the budget could be a non-event this year since the National Telecom Policy (NTP 2012) is likely to be announced within C2012. This would, among other issues cover excess spectrum charges and spectrum renewal charges for incumbent operators.
Utilities *Parag Gupta*	We expect • Withdrawal of MAT on SEZ developer/co-developer • Waiver of import duty on coal • Introduction of customs duty on imported power equipment • Extension of income tax deduction under Section 80 IA • Exemption of withholding tax on ECBs • Some announcement on proposed infrastructure fund

Source: Morgan Stanley Research

Exhibit 10

Central Government Accounts

	Rs bn			YoY%			as % of GDP		
	F2010	F2011	F2012MS	F2010	F2011	F2012MS	F2010	F2011	F2012MS
I] (a) Tax Revenue (Net to Centre)	**4,565**	**5,728**	**6,396**	**3%**	**25%**	**12%**	**7.1%**	**7.3%**	**7.0%**
-- Gross tax revenue	6,245	7,868	8,969	3%	26%	14%	9.7%	10.0%	9.9%
--Less- NCCD transferred to the NCCF*/NDRF	32	36	39	-	-	-	-	-	-
-- Less Share of States	1,648	2,193	2,534	26%	28%	28%	2.6%	2.8%	2.8%
I] (b) Non -Tax Revenue	**1,163**	**2,215**	**1,114**	**20%**	**90%**	**-50%**	**1.8%**	**2.8%**	**1.2%**
-- 3G & BWA receipts	-	1,063	296	-	-	-	-	-	0.3%
II] Revenue Expenditure	**9,118**	**10,391**	**11,580**	**15%**	**14%**	**11%**	**14.1%**	**13.2%**	**12.7%**
-- Interest payments	2131	2408	2,696	11%	13%	12%	3.3%	3.1%	3.0%
-- Non-Interest Revenue Expenditure	6,987	7,984	8,883	16%	14%	11%	10.8%	10.1%	9.8%
III] Revenue Deficit (II minus I)	**3,390**	**2,449**	**4,069**	**34%**	**-28%**	**66%**	**5.2%**	**3.1%**	**4.5%**
IV] Capital Receipts (ex-borrowings)	**332**	**356**	**300**	**395%**	**7%**	**-16%**	**0.5%**	**0.5%**	**0.3%**
-- Recoveries of Loans	86	128	150	40%	48%	18%	0.1%	0.2%	0.2%
-- Disinvestment Proceeds	246	228	150	4243%	-7%	-34%	0.4%	0.3%	0.2%
V] Capital Expenditure	**1,127**	**1,598**	**1,728**	**25%**	**42%**	**8%**	**1.7%**	**2.0%**	**1.9%**
VI] Total Expenditure	**10,245**	**11,989**	**13,308**	**16%**	**17.0%**	**11.0%**	**15.9%**	**15.2%**	**14.6%**
-Additional expenditure (supplementary grants, only cash outgo)	-	-	660	-	-	-	-	-	0.7%
VII] Fiscal Deficit (VI - I - IV)	**4,185**	**3,690**	**5,497**	**-**	**-**	**-**	**6.5%**	**4.7%**	**6.0%**
Fiscal Deficit ex 3G & BWA receipts	***4,185***	***4,753***	***5,757***	**-**	**-**	**-**	***6.5%***	***6.0%***	***6.3%***
Fiscal Deficit ex 3G & BWA receipts (incld off-budget subsidies)	***4,336***	***5,236***	***6,537***	**-**	**-**	-	***6.7%***	***6.6%***	***7.2%***

*includes both 2G and 3G excess spectrum charges collections for F2012; RE = Government Revised Estimates, MSE= Morgan Stanley Research Estimate
Source: RBI, Budget Documents, Morgan Stanley Research

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