Union Budget 2012-13 Preview

Pushed against the wall

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The Union Budget this year is being watched closely, even as progressively, it has lost significance for the markets in the past few years. Given the investment-led slowdown in the economy, with a need for fiscal pump-priming on one hand, and steadily deteriorating public finances on the other, the budget needs to be frugal, reformist and pro-growth at the same time. Not an easy task, especially so given the (populist) demands of the realpolitik.

We believe the government will do all it can to improve sentiment and redeem its image, at least some of it credible. Besides the FY13 fisc (we estimate 5.2%, although the Govt.'s initial estimate would be lower), the market is also looking for the market borrowing figure (our est. Rs5trn), esp. for its impact on the RBI's easing stance.

And for the market, recent outperformance and the headwind of high crude oil price risk a negative reaction if the budget fails to deliver on expectations.

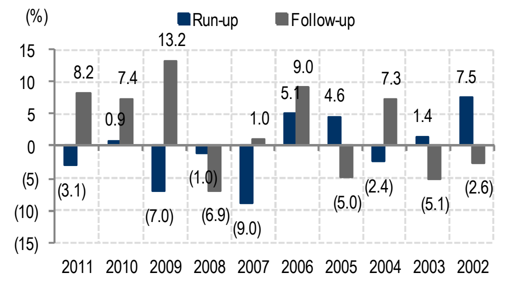
- **Last reformist budget ahead of general elections in 2014:** The 2012-13 Union Budget is the last chance for the government for a course correction towards growth-oriented reforms, and prudent expenditure, two years being essential for tangible change before General Elections in 2014. While monetary policy would get easier, a turn in sentiment would require policy incentives as well. A broad-based macro slowdown, led by stalled investment, stubborn inflation, and high cost of funds, lately joined by resurgent commodity prices ought to make it the case serious enough.

- **Fiscal pump-priming difficult this time around:** Let's face it: Growth is down to 6.5% in FY12E, and little better in FY13E (We expect 7.1%). The last time that happened was in FY09, with the fisc at 6% (except that FY10 saw 8.4% growth. i.e., no bounce this time around). Our FY12 assumption of 5.9% leaves little room for fiscal manoeuvring, with subsidies and interest payments taking up more than 60% of total tax receipts. Corporate investment in the economy has been flat for the last three years, but the Govt. is no position to take over.

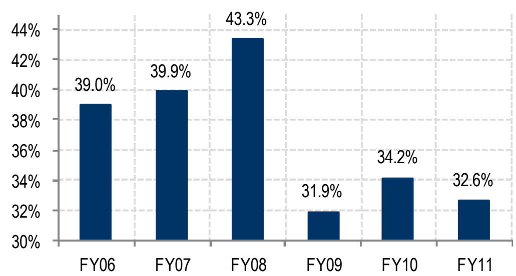
- **Budget likely to look frugal, reformist and pro-investment:** Clearly, expense rationalization (subsidies) is as important as raising revenues (tax off-take, spectrum sales, divestment). While it's time to take hard decisions, the budget would do well to lay down concrete roadmaps (e.g., fuel deregulations, GST), short of destabilizing fragile economic growth. We believe this will translate into increase in select indirect taxes, lower subsidies, incremental clarity on long-pending reform measures and a push for investments/ infrastructure through better incentives. One might also see a smattering of 'forward' reforms like direct cash transfers.

- **However, expectations increase risks of a disappointment?** Markets tumbled in 2011 on inflation and policy paralysis, the early rally has pushed valuations from cycle-low multiples. Ample liquidity, improved risk appetite (and of course, range-bound oil) may continue to re-rate the markets further. However, widely-held expectations of a reformist budget, fiscal consolidation and reforms (amidst serious need for it) have increased the risk of a disappointment if the budget fails to deliver.

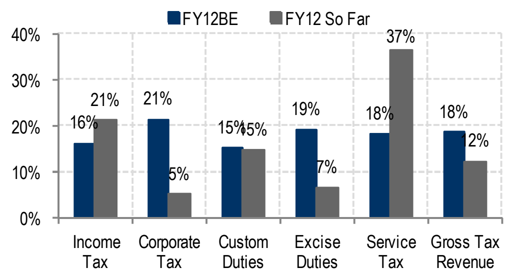
Pre- and post-Budget market returns (1-month)



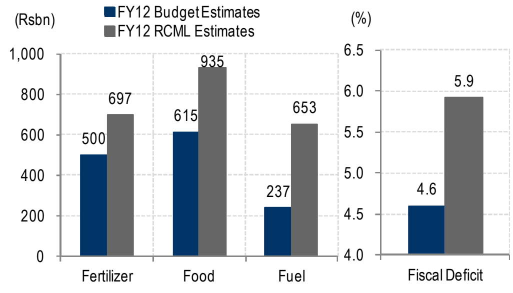
Private sector capex/GFCF (constant prices)



FY12 Tax-collections thus far



FY12 budget - under-accounting of subsidies



Union Budget 2012-13

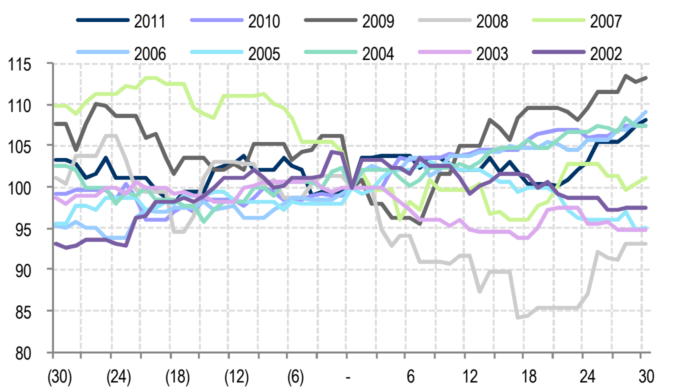
Pushed against the wall

Last reformist Budget ahead of general elections in 2014

The Union Budget 2012-13 is the last chance for the government for a course correction ahead of next year's likely populist election Budget. The lower revenue collection (on industrial slowdown) and lower divestment proceeds (on weak markets) along with under-accounted subsidies (fuel and fertilizer) have translated into messy math for public finances in FY12. This has led to higher borrowing in FY12E, with a massive 5.9% fiscal deficit/GDP versus Budget estimate of 4.6%. The FY14 Union Budget will likely be populist ahead of the general elections in 2014 and this would mean that the government would likely create some space for larger social spending in the FY14 budget. This would also mean that the chances of a prudent and reformist budget in FY13 are very high.

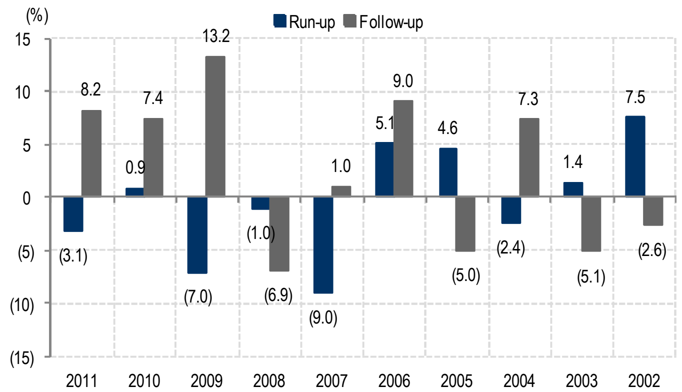
The Union Budget has had progressively lower importance in the past as the last few budgets have avoided big-ticket policy reform announcements, which in any case tended to come throughout the year instead of end-Feb. However, this time is different as given the policy paralysis and limited room for fiscal profligacy; it is in the Govt.'s interest to the opportunity to redeem the Government's image and kick-start reforms in a big way. The idea here is to incentivise investments and at the same time keep a check on the deficit by reducing inefficient expenditure, a task that is easier said than done.

Fig 1 - Pre- and post-Budget market performance



Source: RCML Research

Fig 2 - Pre- and post-Budget market returns (1-month)



Source: RCML Research

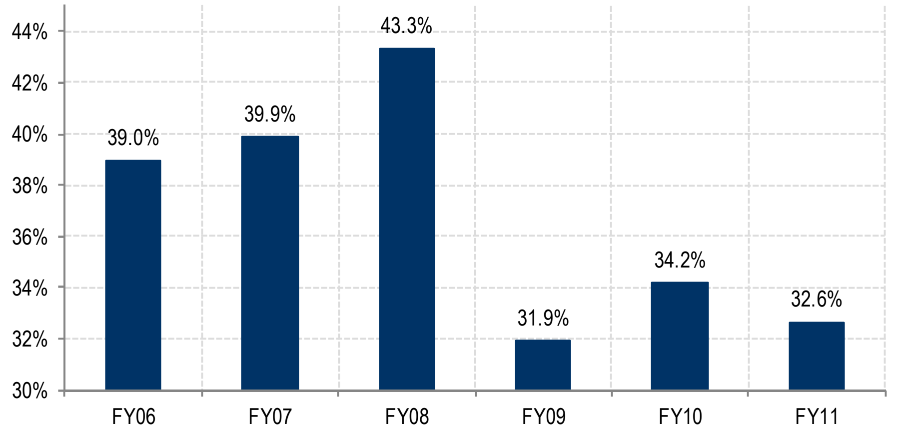
Slowdown in the economy is investment-led and needs pro-cyclical measures:

The capital expenditure/total expenditure—a measure of capital spends by the government—fell from ~18% in FY01-FY08 to ~13% in FY12E as the government spent less on the plan and non-plan capital expenditure to counter ballooning non-plan revenue expenditure i.e. subsidies. This has meant that while the borrowing by the government has increased substantially at the expense of the private sector, the much needed capital expenditure has taken a hit (aggregate plan and non-plan capital expenditure down 1.4% at Rs 1.6trn in FY12BE over FY11).

While gross fixed capital formation as a percentage of GDP has been falling from 35% in Q2FY10 to 30% in Q3FY12, what is worrisome is that the private share of the gross capital formation has also fallen from a high of ~43% in FY08 to ~33% in FY12. The new project announcements have fallen 44% for the first nine months of the current fiscal to Rs 7.3trn from Rs 13.2trn a year ago. The share of private projects has also fallen to 47.2% from 65.4% a year ago, highlighting the subdued sentiment in the private sector which has been the key driver of investments during the past decade. This fall in the investments will likely affect India's potential growth over the next few years.

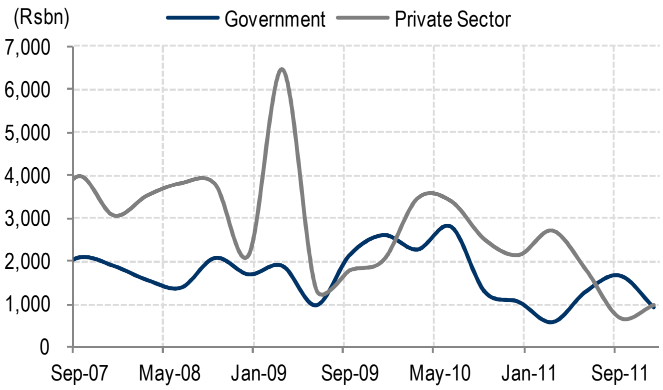
To turn the sentiment from such a severe slowdown in the investments, policy incentives are required in addition to an easy monetary policy even as the scope for pro-cyclical expenditure by the government is limited. Additionally, a boost to the already strong domestic consumption through monetary and fiscal easing in the face of capacity constraints and already high inflation would only intensify the inflation problem.

Fig 3 - Private sector capex/GFCF (constant prices)



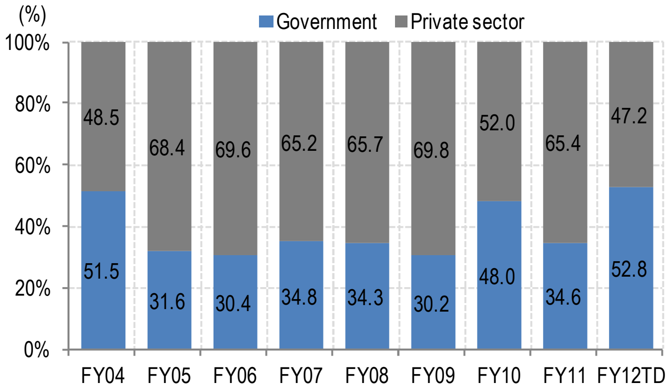
Source: RCML Research, CMIE

Fig 4 - New project announcements



Source: RCML Research, CMIE

Fig 5 - Public and private share of investments



Source: RCML Research, CMIE

Fiscal pump priming for investments difficult this time around...

Let's face it: Growth is down to 6.5% in FY12E, and little better in FY13E (We expect 7.1%). The last time that happened was in FY09, with the fisc at 6% (except that FY10 saw 8.4% growth. i.e., no bounce this time around). Our FY12 assumption of 5.9% leaves little room for fiscal manoeuvring, with subsidies and interest payments taking up more than 60% of total tax receipts. Corporate investment in the economy has been flat for the last three years, but the Govt. is no position to take over even as the government would like to make sure that the growth does not fall further. The only tool that will not cost the bucks and still help improve sentiments, attract investments into India and facilitate growth remains the much needed *"reforms"*.

...given the messy state of public finances in FY12

The double whammy of lower tax/non-tax revenue collection (on lower growth and weak markets) along with higher subsidy burden (on higher crude, fertiliser commodity prices) has translated in the government raising its borrowing target for the year two times from Rs 4trn earlier to Rs 5.1trn now.

The excise and the corporate taxes have lagged Budget estimates so far and the gross tax collection is likely to miss the budgeted target of 18%YoY (12%YoY so far) despite strong service tax collections (37%YoY so far versus the budgeted 18%).

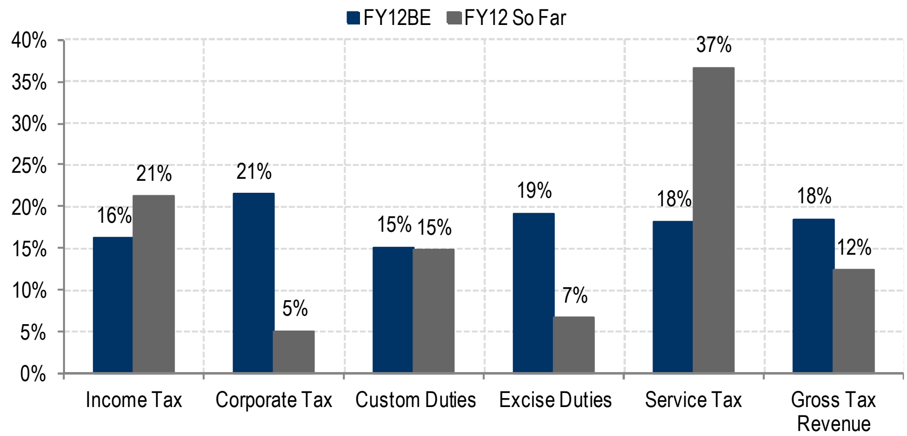
Fig 6 - Fiscal math for FY12

(Rsbn)	FY12BE	%YoY	FY12E	%YoY	FY12 So Far	% of BE
Central govt. net tax revenue	6,645	16	6,369	11	4,586	69
Non-tax revenue	1,254	(43)	1,254	(43)	906	72
Central govt. revenue receipts	**7,899**	**(1)**	**7,624**	**(4)**	**5,491**	**70**
Non-debt Capital Receipts	551	55	250	(30)	180	33
Total Receipts	**8,450**	**2**	**7,874**	**(5)**	**5,671**	**67**
Non-plan Expenditure	8,162	(1)	9,102	11	7,081	87
Plan Expenditure	4,415	17	4,151	10	2,940	67
Total Expenditure	**12,577**	**5**	**13,253**	**11**	**10,020**	**80**
Fiscal Deficit	**(4,127)**	**12**	**(5,379)**	**46**	**(4,349)**	**105**
Nominal GDP	89,783	14	90,931	15	90,931	101
Fiscal Deficit/GDP	**4.6**		**5.9**		**4.8**	**104**

Source: RCML Research, CGA

While the revenue-collection is often back-ended, a clearly visible slowdown in the economy (Q3FY12 GDP at 6.1%, lowest in 12 quarters) in the second half of FY12 on lower investments driven by hawkish monetary policy is not likely to help matters either. With our expectation of a gradual recovery in the macro indicators and growth through FY13, the FY13 picture does not look very encouraging either.

Fig 7 - Tax collection thus far



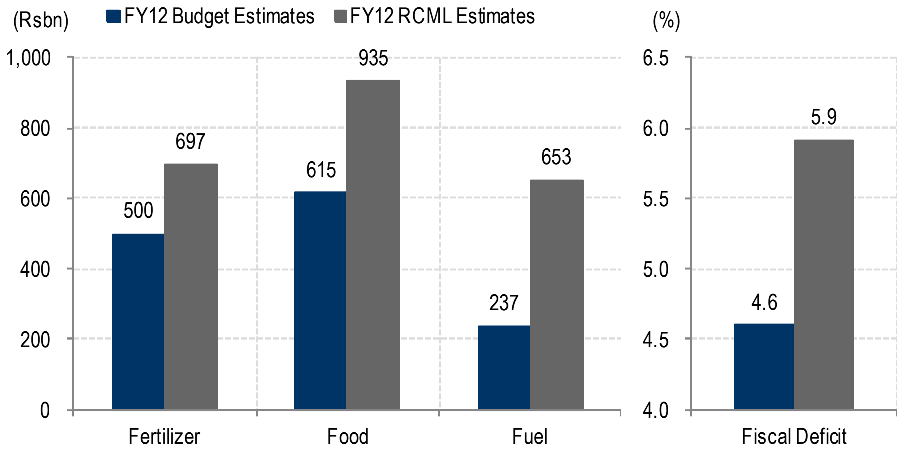
Source: RCML Research, CGA

The budgeted divestment target of Rs 400bn also looks distant given the divestment proceeds of ~Rs 135bn so far (including the recent ONGC auction). While the markets have seen an improvement in the sentiment in the past couple of months and levers exist in FY13 in the form of 2G auction, divestment through the new auction methodology, PSU buy-backs, etc. we take note that the divestment proceeds in the best of the times in FY11 have been ~Rs 220bn versus the budgeted Rs 400bn. The uncertainty over the extent of spectrum to be auctioned and likely participants in the probable 2G auctions make us conservative on the non-debt capital receipts in FY13.

The subsidy expenditure as a share of total receipts of the government has increased from ~13% in FY01-FY08 to ~30% in FY12E. Higher crude oil prices, under-allocation of fuel subsidies and higher costs for fertiliser inputs have all contributed to a high subsidy bill versus expectations in FY12 (our estimate Rs 238bn versus budgeted Rs 144bn). Any further measure that aims to push consumption (or income transfers to rural India) will cause inflation to remain higher for longer, delay the easing of the rates and consequently delay the investment cycle further.

Despite the expected fuel price hikes post the Uttar Pradesh (UP) elections and the proposed reduction in the fertiliser subsidies, we think, the subsidy bill is going to be high if the government implements the Food Security Bill and the crude oil prices continue to remain upbeat on geo-political tensions.

Fig 8 - 2011-12 union budget - under-accounting of subsidies



Source: RCML Research, indiabudget, nic.in

This would likely mean that the investment push in the Budget has to be given within the constraints of a high fiscal deficit, not-so-buoyant revenue receipts and a high subsidy bill.

Budget is likely to be frugal, reformist, pro-investments

We think the street is looking up to the FM to put the house in order and boost market sentiment further, which already seems upbeat since the start of the year on account of the start of the easing monetary cycle and improved risk appetite across the globe. Cutting down on populist/inefficient expenditure wherever possible is the need of the hour. While reforms have been suggested in all the three main heads of the subsidies (food—targeted and a more efficient PDS, fuel—fuel price de-regulation—Dr. Kirit Parikh Committee report, fertilizer—Urea Policy), they have not been implemented so far. The earlier set target of fiscal deficit/GDP of 3% in FY15 now looks unachievable (especially in the absence of some hard decisions on subsidies and on social spending) and the markets will give a thumbs-up to a budget with genuine intent to push through reforms and reduce subsidies through steps such as:

- Improvement in revenue-receipts by **rewinding sops extended during the crisis on indirect taxes and realignment of Service tax with the GST along with introduction of negative list**.
- **Roadmap for rationalisation of subsidies** and ultimately, market-linked prices wherever possible, so that demand adjusts to the global commodity prices. While global crude oil prices is anybody's call, internalising global commodity prices is the need of the hour as the regulated and subsidised prices do not let the domestic demand adjust to parity prices, which in-turn results in higher/inefficient consumption and larger subsidy bill. Given the inflation dynamics and the market expectations, all the fuel prices may not be de-regulated immediately; however, there is a need for a comprehensive plan for the same in the form of a roadmap with clearly defined timelines for eventual complete de-regulation.
- **Improvement in the subsidy distribution mechanism** to avoid leakages and ensure targeted subsidy disbursal.
- **Flat NREGS spend:** In FY12, the NREGS allocation remained flat at Rs 400bn over FY11. Concerns have been voiced over the impact of NREGS on the wage levels in rural

India, but FY12 saw NREGS allocation remaining flat at ~Rs 400bn over FY11. Given the lower leakages in the disbursement of NREGS funds, the current fiscal has seen disbursements of Rs 220bn versus an allocation of Rs 400bn in the budget. This makes a case for flat NREGS allocation in FY13 as well.

- **Clear divestment agenda and policy** instead of the current *ad-hoc* one (especially after the ONGC episode which indicated that there is no appetite for *ad-hoc* divestment and prices for PSU paper).

- **Push for reformist agenda and sacrosanct timelines** on FDI in multi-brand retail/GST/DTC, etc.

- Part roll-out of DTC/GST even as the actual/full-fledged implementation looks some time away.

Fiscal consolidation will be positive for easing monetary stance as well

The Reserve Bank of India (RBI) has time and again voiced concerns over a loose fiscal policy and consequently, limited room for the monetary policy to react to a slowdown in the context of stubborn inflation. A fiscally responsible Budget may also mean a more comfortable RBI on easing rates—likely positive for the investments and the markets.

The print may look good but the devil lies in details

Empirical evidence suggests that there has been a wide disconnect between the budgeted numbers and the actual expenditure/receipts. The budget estimates are often rosy even as the expenditure has seen additions through multiple supplementary grants and on account of higher subsidy bill. Thus, while the print may suggest fiscal consolidation, we would like to watch out for the following as history tells us that the devil lies in details:

- **Accounted subsidies** (if realistic) for fuel, fertilisers and food will provide some insight into government position on fuel price de-regulation and the food security bill form and timeline.

- **Market borrowings of the government in FY13:** High borrowings in FY12 have meant lesser and expensive capital resources for the private sector.

- **GDP growth assumption for FY13** (again, if realistic) will peep into the government's expectation on economic recovery.

- **Social sector spending and NREGS allocation:** While health and education spending are essential, concerns have been raised over NREGS spending, which is often held responsible for prohibiting labour migration and increasing labour costs.

Fig 9 - Union Budget: FY13 expectations

(Rsbn)	FY12BE	%YoY	FY12E	%YoY	FY13RCMLE	%YoY
Central govt. net tax revenue	6,645	16	6,369	11	7,281	14
Non-tax revenue	1,254	(43)	1,254	(43)	1,330	6
Central govt. revenue receipts	**7,899**	**(1)**	**7,624**	**(4)**	**8,611**	**13**
Non-debt Capital Receipts	551	55	250	(30)	309	24
Total Receipts	**8,450**	**2**	**7,874**	**(5)**	**8,920**	**13**
Non-plan Expenditure	8,162	(1)	9,102	11	9,763	7
Plan Expenditure	4,415	17	4,151	10	4,566	10
Total Expenditure	**12,577**	**5**	**13,253**	**11**	**14,329**	**8**
Fiscal Deficit	**(4,127)**	**12**	**(5,379)**	**46**	**(5,409)**	**1**
Fiscal Deficit/GDP	**4.6**		**5.9**		**5.2**	

Source: RCML Research, indiabudget.nic.in

Fig 10 - Tax-receipts and subsidy math: FY13 Union Budget

(Rsbn)	FY12BE	%YoY	FY12E	%YoY	FY13E	%YoY
Key Receipts						
Direct Taxes	**5,245**	**19.8**	**5,065**	**15.7**	**5,893**	**16.3**
of which						
Income Tax	1,645	16.2	1,642	16.0	1,905	16.0
Corporate Tax	3,600	21.5	3,423	15.5	3,988	16.5
Indirect Taxes	**4,079**	**16.9**	**3,980**	**14.1**	**4,606**	**15.7**
of which						
Custom Duties	1,517	15.1	1,496	13.5	1,713	14.5
Excise Duties	1,636	19.2	1,537	12.0	1,768	15.0
Service Tax	820	18.2	840	21.0	1,016	21.0
Subsidies						
Food Subsidy	606	(0.0)	697	15.0	980	40.0
Fertilizer Subsidy	500	(9.1)	935	70.0	750	(20.0)
Oil Subsidy	236	(38.4)	653	70.0	690	5.0

Source: RCML Research, indiabudget.nic.in

Key assumptions

- Implementation of Food Security Bill in the current fiscal is assumed and will cost Rs 980bn in the first year of implementation.
- Roll back of excise to 12% and increase in the Service Tax by 2% to 12%.
- Increase in diesel, LPG and kerosene prices by Rs6/ltr, Rs50/Cyl. and Rs2/ltr through FY13 and crude oil at US$105/bbl.
- Divestment proceeds of Rs 150bn.

Fig 11 - Sector implications of Union Budget 2012-13

Sector	Budget expectations	Implication
Auto	Increase in excise duty	Marginally negative for farm mechanisation and two-wheeler demand
	Specific excise duty on diesel passenger vehicles	Likely to affect UV/diesel passenger car players, **M&M** (38%), **Tata Motors** (10%), **Maruti** (30%)
FMCG	Excise duty hike	A hike of 5-10% on cigarettes can be passed through and may not impact much but a substantially higher excise duty on cigarettes will impact **ITC**
	Lower spend on flagship schemes	Sentimentally negative for FMCG cos. with high rural share such as **HUVR** and **DABUR**
	Personal Income Tax brackets	Hike in personal income tax slabs will be a positive for the sector in general
Infrastructure	Infra-bonds	Increase in the (company) borrowing limit for infra-bonds in order to give a push to infrastructure development, positive for the sector Any increase in the (personal) tax exemption limit for infra bonds will incrementally address funding constraints for the sector
	Continued spending on roads and pick-up in rail spending	Expect the government to raise infra spend in the year, esp. roads/rail – likely positive for L&T and midcap contractors
	Increase in taxes as differential between MAT and IT comes down	Any increase in MAT in the context of a tight fiscal situation would be negative for the sector
Capital Goods	Import duty on power equipment	Import duties on power equipment at 10-12% following demands from domestic power equipment companies will be marginally positive even as high domestic competition will continue to remain
Financials	Fiscal deficit and borrowing target	Fiscal consolidation is very crucial from a macro perspective and the banks will like better fiscal policies and the supply of government securities should be limited
	Clarity on restructuring of power sector assets	More clarity on the SEB issue will be sentimentally positive for the sector
	Increase in exemption limit for borrower on housing loans	Positive for the sector and housing finance companies
Cement	Elimination of import duty on thermal coal, pet-coke and Gypsum	Positive for the sector; imported coal to benefit largely India cement, Ultratech and Ambuja
	Increase in excise duty	Negative for the sector as a whole
	Push for infrastructure spending	Positive for the sector
Real Estate	Clarity on ECB for Real estate companies	ECB to Real estate under approval route stands withdrawn from Dec'10. Extension of the same will be positive for Real estate companies
	Increase in tax benefit for home loan Interest (current Rs.0.15mn) and Principal repayment (Current Rs.0.1mn)	Positive for the residential developers
	Signals of including Real estate under GST	Positive for the sector as it will lead to lower tax burden for the real estate developers (stamp duty)
	Clarity on tax implication on SEZ (MAT on SEZ)	Positive if MAT on SEZ profits is removed.
	Tax incentives to developers for mid-income housing/Slum rehab schemes	Positive
	Further change in limit for home loan eligibility for priority sector lending	Marginally positive if home/loan value increased from current limit of Rs2.5mn/1.5mn respectively
Power	Elimination of import duty on thermal coal	Likely positive for players dependent on imported coal such as **Adani Power** and **JSW Energy**
	Extension of 80-IA benefit (MAT exemption based on year of commissioning)	Positive for the sector as a whole
	Clarity on restructuring of power sector assets	Clarity on the SEB issue will be sentimentally positive for the sector
	Increase in taxes as differential between MAT and IT comes down	Negative for the sector
Telecom	2G auction revenue	Key factor to watch out for even as uncertainties remain on size and participants of the auction
Energy	Under-recoveries and fuel taxes	Increase in tax and subsidy math for fuel subsidies will likely hint at possible fuel price hikes etc. No change in excise/customs expected.
	100% depreciation on fuel quality up-gradation projects	100% depreciation could be allowed on fuel quality upgradation projects as the oil refineries are making substantial capital investment for meeting the stringent product specifications
	Extending the validity of the deduction u/s 808B (9)	The sunset clause provides a tax holiday to companies which begin refining between October 1, 1998 and March 31, 2012. Some companies could not finish their projects on time due to factors beyond their control. The government should encourage investment in grass root refineries and major expansion of the refineries by extending the tax holiday up to the end of the 12th Plan period i.e. up to March 2017
	Custom duty exemption for LNG	A 5% custom duty is charged on import of LNG. No credit is allowed for the custom duty. Hence, this goes into cost which is ultimately passed on to the customers who are mainly from the power and fertiliser sectors. It is therefore suggested that in line with the benefit given to imported crude oil, the same may be extended to imported LNG
Media & Distribution	Reduction of customs duty on set-top boxes	Positive for all distribution companies

Source: RCML Research

High market expectations increase risks of a disappointment

While the markets tumbled in 2011 on concerns over inflation and policy paralysis, the rally since the start of the year has pushed the valuations from the cycle low multiples.

Flowing liquidity taps from the central banks around the globe and consequently sloshing liquidity, range-bound crude oil on higher supply and demand destruction at higher prices and increased risk appetite may continue to re-rate the markets further. However, widely held expectations of a reformist budget amidst serious need for investments, fiscal consolidation and reforms have increased the risk of a disappointment if the budget fails to deliver.

Fig 12 - MSCI India 12-month forward PE multiple

Source: RCML Research, Datastream, IBES

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Hold	Between 15% and –5%
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