All Eyes On The Budgets

Monday, February 22, 2016

While Railway Minister Suresh Prabhu, is gearing up to present his second Rail Budget on February 25, Finance Minister Arun Jaitley will present the Union Budget on Monday, February 29. Both these events will be keenly watched as their influence on the economy and the stock markets will be an impactful one. ADC looks into the expectations and voices the views of the market leaders and what they think could unfold through the budgets

Will finance minister Arun Jaitley adhere to the original fiscal consolidation plan or slow the pace of consolidation on Feb 29th?
India's government originally targeted a fiscal deficit of 3.5% of GDP for FY17 (year starting April 2016) and 3.0% in FY18. However, with increased claims on central-government finances (pay increases for public-sector employees) and a gradual growth recovery, pressure has increased to slow the pace of fiscal consolidation, says Standard Chartered in a Report. It expects the government to target a fiscal deficit of 3.7% of GDP. "However, with the Reserve Bank of India (RBI) strongly advocating the merits of adhering to the original plan even if it slows growth in the short run, we think the likelihood of the government deciding to stick to its fiscal consolidation plan despite all odds has increased".

Says the Standard Chartered report, "We agree with the merits of adhering to the original fiscal consolidation plan. The need to maintain and enhance policy credibility is strong given current global market volatility. We believe revising the fiscal consolidation plan for a second straight year will erode investor confidence in the government's commitment to implementing such plans. A slower pace of fiscal consolidation may also result in a negative impact on the aggregate fiscal deficit and public debt, if states, which have been fiscally prudent so far, decide to follow a similar path".

"However, the 0.4% of GDP reduction in productive expenditure necessary to achieve the 3.5% fiscal deficit target in FY17 may lead to growth headwinds. We do not rule out a further reduction in such expenditure in FY18 as the government attempts to narrow the fiscal deficit to 3.0% of GDP that year. Public investment has driven the country's economic recovery in the past 18 months, and this will likely be curtailed to achieve this reduction. With private-sector investment unlikely to come to fruition soon, we believe the nascent recovery may suffer serious setbacks.

If the government adheres to its original plan, adopting alternative policies could mitigate growth headwinds, in our view".

Standard Standard Chartered goes on to say"First, we believe that if the government taps its existing funding arrangements (with the largest public-sector insurance company focused on railway infrastructure development), it could meet at least half the reduction in production expenditure. Second, new alternative sources of funding, such as the National Infrastructure Investment Fund (NIIF), could be made operational to meet at least a fourth of the reduction.

Third, we believe the central government needs to further streamline its expenditure. According to the Fourteenth Finance Commission (FFC), with a higher tax devolution to state governments, the majority of more than 30 centrally sponsored schemes with a total allocation of INR 1.2tn (0.9% of GDP) should have been transferred to state governments. However, the central government last year decided to continue with most of these schemes to facilitate a smooth transition. We believe that after a year of FFC implementation, further streamlining of the expenditure-sharing plan between the central and state governments is necessary. This should enable the central and state governments to be more disciplined in fiscal management".

Expectations of major policy announcements during this year's budget speech are high. Measures to boost infrastructure investment will be closely watched; however, given the limited fiscal space, a sharp increase in such spending looks unlikely. Standard Chartered expect policies to focus on four themes: (1) securing alternative sources to boost infrastructure investment, (2) measures to relieve banking-sector stress, (3) greater certainty and transparency regarding the tax regime, and (4) measures to address the distressed agricultural and rural segments of the economy.

For the rates market, a credible fiscal deficit consolidation plan is important from two perspectives. First, the narrower the fiscal deficit, the less Indian government bond (IGB) supply required. Second, fiscal consolidation may pave the way for further monetary easing by the RBI. Market participants currently believe a FY17 fiscal deficit target of 3.7% of GDP is more likely than 3.5%.

A fiscal deficit of 3.7% of GDP implies a funding requirement of c.INR 5.52tn. Assuming that the government continues to finance c.85% of its fiscal requirement via market borrowing, we expect net market borrowing (IGBs + T-bills) of c.INR 4.70tn in FY17, c.3% higher than in FY16. We expect the FY16 debt switch and buybacks to reduce FY17 redemptions by c.INR 500bn to INR 1.73tn. We estimate gross IGB issuance of INR 6.4tn.

Using similar assumptions of financing and redemptions, a FY17 fiscal deficit target of 3.5% of GDP should lead to gross market borrowing of c.INR 6.17tn. While the market will closely watch for details, its initial response will likely be positive due to lower IGB supply – at least in H1-FY17 – and an increased likelihood of a near-term repo rate cut by the RBI.

Kotak Securities is of the view that the Finance Minister will present the 2016-17 budget" amid a weak global setup and an anemic domestic recovery. The consumption stimulus (OROP and 7th Pay Commission) and investment stimulus (with private sector capex is yet to recover) are expected to result in higher spends. Thus, the FM will have to be resourceful enough to meet the FD targets. We look for an 'Achievable' and 'Sustainable' budget; one of the pre-requisites for further monetary policy easing by RBI".

Kotak believes that the "FM's priority in the 2016-17 budget will be higher growth, with fiscal rectitude, we believe. With the private sector capex yet to pick up, he will budget for higher plan capital expenditure (investments), in addition to the higher spends on OROP and CPC, which need to be factored in. These will be proposed to be financed by higher revenues from divestment/privatisation, higher indirect tax rates, telecom auctions and better tax compliance, apart from a cut in non-plan expenditure (subsidies) via DBT.

A lower fiscal deficit will leave more money available for the private sector, help in easing inflation, and moderate interest rates further. We expect targets under the FRBM Act to be largely maintained. We expect the FM to target a fiscal deficit of 3.7% for FY17 and budget for a gradual reduction in fiscal deficit per annum to 2.5% by FY19".

Kotak securities also expects the FM to target real GDP growth of 7.7% in FY17 and bring it to over 8% next year. Larger and targeted plan expenditure capital outlays, with strict implementation timelines, would likely be announced, to ensure economic recovery and sustainable growth. "We expect plan expenditure target to increase by 30% over FY16RE. The budget will aim to provide an investment - led supply aid to growth (with private sector participation via Make in India campaign) as well as a consumption - led demand pull growth via 7th CPC, OROP and DBT of subsidies" it said.

On taxation front, it expects the Government to initiate the reform process in direct taxes, in line with the announcements of the previous budget. "The tax rate is expected to gradually come down from 30% to 25%, with a corresponding removal of exemptions / deductions available currently. On indirect taxes, we expect increase in service tax rate to bring it in line with the proposed GST rate of about 17-18%. Similarly, excise duties will likely be levied on various exempt items and increased for various items which are currently taxed at concessional rates. We are not expecting change in base rate of excise duty" it said.

The FM will have to restrict non plan expenditure to meet his FD targets. While the food subsidy burden will be taken up, we believe the FM will budget for lower fuel subsidy bill on the back of lower crude prices. He will also better target subsidies through the JAM trinity. The government has already announced on January 1, the launch of DBT for kerosene subsidy in a bid to cut down the diversion and black marketing of the fuel. The kerosene subsidy in FY15 was pegged at about Rs.248bn. As per reports, Direct Benefit Transfer (DBT) for LPG had resulted in savings of about Rs.140bn in FY15. We expect DBT to be gradually used for more subsidies. Implementation of DBT for fertilizer and crop subsidy could result in substantial savings.

To provide higher employment opportunities and to make the workforce employable, we expect measures to promote the 'Make in India' and 'Skill India' initiative. We also expect higher allocations towards agriculture and rural sector to support rural growth, after two continuous drought years in the country.

We expect the divestment target to be increased to Rs.500bn in FY17 v/s the FY16RE of Rs.200bn. Tax revenue targets (net) may be set at Rs.10.2tn, an 8% growth over FY16RE. Customs duty may be tweaked on several items to further the 'Make in India' cause. We expect implementation of GAAR to be postponed to FY18. We also expect tax benefits for the export-oriented sectors, in view of the consistently falling exports and some measures to restrict dumping.

"We do not expect any major initiatives for the stock markets. Some minor adjustments could be in offing for increasing retail participation in equities (directly/indirectly). Reduction in STT, if any, will be cheered by the markets, while any tax liability on LTCG will be a severe negative. We believe focus of the markets will be largely on fiscal prudence, on effective implementation of investments, and on sectors which are impacted by the budget proposals. Off-budget investment and governance reforms announcements will continue to impact the markets" it said.

Industry Leaders Expect...
The real estate sector has seen its worst year since Independence, in 2015. Acche din - we remain waiting for the same. The several structural reforms that have been planned by the government needs to get passed in a hurry in Parliament, including GST. Specifically for real estate, we need single window clearances and for the affordable housing sector, some meaningful steps that will create both supply and provide encouragement amongst potential home buyers – such as lower mortgage rates, lower stamp and registration charges, lower taxes.
Rohit Poddar
MD, Poddar Housing

We have to make things conducive for GST and corporate taxation rates needs to reduce, which is a must. Reforms for IT SEZ has to strengthen and benefits must flow to the occupiers. There needs to be more clarity on the issue over masala bonds. Importance must be given to the objective of smart cities and private developments. The definition of affordable housing has to be rationalized. Also why ECBs should not be permitted for real estate?
Srinivasan Gopalan,
CEO, Ozone Group

The real estate sector continues to remain sensitive to government policies for growth. The sector is just emerging from a prolonged slowdown, and is looking for signs of light at the end of the tunnel. This makes Union Budget 2016 critical, and the real estate industry has many expectations from it. Prime Minister Narendra Modi led government has already taken several steps in the right moves creating the perfect atmosphere for the industry. It has already started work on developing smart cities, increase in foreign direct investment and "Housing for All-2022" that have boosted the sentiments of both buyers and developers. But we feel it's right time that the sector gets industry status that has been a long pending demand of the real estate sector as developers can then avail finances at cheaper rates from financial institutions that will spur economic growth.
Rohit Katyal,
Founder Director, Capacit'e Infraprojects Ltd.

"The government should set up Infrastructure Dispute Redressal Tribunals to resolve long pending and tortuous disputes in the infrastructure sector. Also, the Companies Act, 2013 should be streamlined to make it more business-friendly, which will help achieve the government's objective of improving the ease of doing business. Tax terrorism has increased and therefore the government should introduce guidelines so that tax authorities cannot summarily disallow expenses and slap notional income in order to increase tax revenue."
Hemant Kanoria,
CMD, Srei Infrastructure Finance

The Finance Minister and his Budget making team has limited amount of maneuverability, if they want to make realistic projections of revenue and expenditures in the Union Budget. Thus, govt. is likely to defer the fiscal consolidation roadmap by another year. Our estimate of fiscal deficit for FY16 and FY17 are 4.0% and 3.8% respectively. Thus, there will still be consolidation of fiscal numbers, but at a slower pace. This will also be counter-cyclical. As long as the spending mix of the government is improving in favour of higher capex (in infrastructure like roads, railways, ports, irrigation etc), one should not be too concerned about the fiscal deficit ratio consolidating at a slower pace. This is likely to enhance the productivity of the economy in the medium to longer term and lead to faster expansion of GDP in the denominator of the ratio.
Jay Shankar,
Chief India Economist, Religare Capital Markets

Though the government has undertaken positive steps over the last 12 months such as the relaxation in FDI norms, finalization of the Real Estate Regulatory Bill, amendments to the REIT regulations; we believe that certain specific policy changes and further fine-tuning of fiscal reforms are required to create a multiplier effect on the economy at large. This particularly when the recent data has shown a contraction in the annual industrial output amidst an already reeling global economy.
Deep Kantawala
Head, ICS Corporate Advisors

Infrastructure should be main focus of this year's budget. 'The Make In India' campaigns success hinges totally on support system and enabling environment. India needs faster & efficient connectivity between ports, railways to the site /plants that would reduce logistics cost which is probably one of the highest in the world for movement of goods.
Umesh Revankar,
MD & CEO, Shriram Transport Finance

The FY 2016-17 budget is crucial for the IT/ITES and Engineering services industry. With this budget, we expect announcements which may foster a better business environment and increase the ease of doing business in India. The IT industry in the country has been facing several challenges due to lack of clarity in transfer pricing norms. We are hopeful that the upcoming budget will address this and a few other essential elements like a correction in the prevailing highinterest rates of 20-30% for safe harbor margins. Furthermore, the foreign trade policies should include benefits of Services Exports from India Scheme (SEIS) for Software Technology Parks of India (STPI) units. Currently, without such benefits, STPI units are at a disadvantage as comparedwith their SEZ counterparts for the same services.
BVR Mohan Reddy,
Chairman NASSCOM

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