more give, less take

India Budget: 2014-15

NAB Group Economics

July 2014

National Australia Bank

Summary & Overview

- *India's new Finance Minister, Arun Jaitley, delivered his maiden Budget on the 10th of July. It was a good document, albeit not a 'game changer', and needs to be followed up with further action and implementation.*
- *There were positives for consumers, infrastructure spending, real estate, manufacturing, higher limits for FDI in insurance and defence, as well as taxation incentives for Foreign portfolio investors. There was a commitment to avoid retrospective taxation – something which has been a bone of contention among foreign investors - and a greater focus on federalism, with increased funding allocation to States to deliver services.*
- *The budget, however, is extremely optimistic about the Fiscal Deficit target of 4.1%, which would likely be missed unless the Government sharply compresses expenditure, increases divestment or rolls over subsidies.*
- *Further, no specific timeline was set regarding the implementation of the GST and a reduction in subsidies – although the Government did signal its intent to work towards a GST, and monitor subsidy payments under the oversight of an Expenditure Commission.*
- *It is important for further progress to be made in subsequent Budgets, commencing with the 2015-16 Budget next year.*
- *On growth, NAB Economics is maintaining its forecast of 5.2% for 2014 and 5.8% in 2015. The forecasts are broadly in line with the lower estimates of forecasts from the pre-Budget Economic Survey. Whilst the measures in the Budget are broadly supportive of growth, issues related to implementation, a weak monsoon, geopolitical risks – potentially triggering higher oil prices, pose headwinds.*

Fiscal Deficit

- The Finance Minister projected a 4.1% deficit for the 2014-15 Financial Year. This is highly optimistic, given the deficit overshoot in the first two months of the current fiscal year, due to the carryover of previous year subsidy payments. Besides, the Government is forecasting a deficit of 3.6% in 2015/16, and 3% in 2016/17.

- Further, the projections assume Gross Tax Revenue growth around 18%, and tax elasticity (responsiveness of tax revenues to nominal GDP) of around 1.4, compared with 0.8 in the previous financial year.

- The Government is also targetting Divestments worth INR 634 bn, which is plausible given the current buoyancy in India's equity markets. In fact, the Government has already commenced this process by seeking bids for a USD 3bn sale in ONGC (Oil & Natural Gas Corporation), India's largest energy explorer.

- One omission is a lack of a defined timetable to implement a Goods and Services Tax, although the Government did signal its intention to do so.

- On the expenditure side, it has budgeted for a 2% increase in subsidies: there is increased funding allocated for food and fertiliser subsidies, the former impacted by the *Food Subsidy Bill*. However, there is a reduction in the allocation for petroleum subsidies.

- One omission has been a firm commitment to a phased decline in overall subsidy spending – something which should be tackled in subsequent Budgets. The Government, has, however indicated that it would carefully monitor spending through an 'Expenditure Commission'.

- **Implications:** The Government has committed itself to a very ambitious and optimistic fiscal consolidation agenda. It may need to increase the rate of divestments, cut Plan (agreed by the Planning Commission) Expenditure or roll over subsidy payments to meet the agreed targets. The key issues, going forward, relates to progress regarding the adoption of a GST, as well as a defined program for cutting subsidies.

Figure 1: Fiscal Deficit Projections

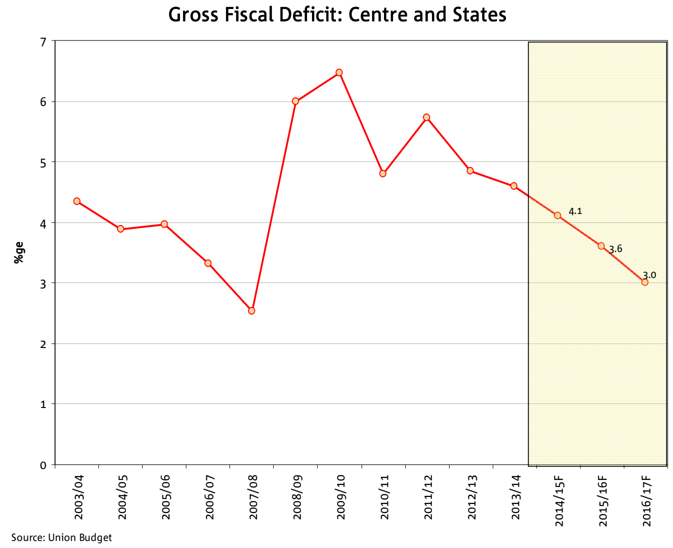
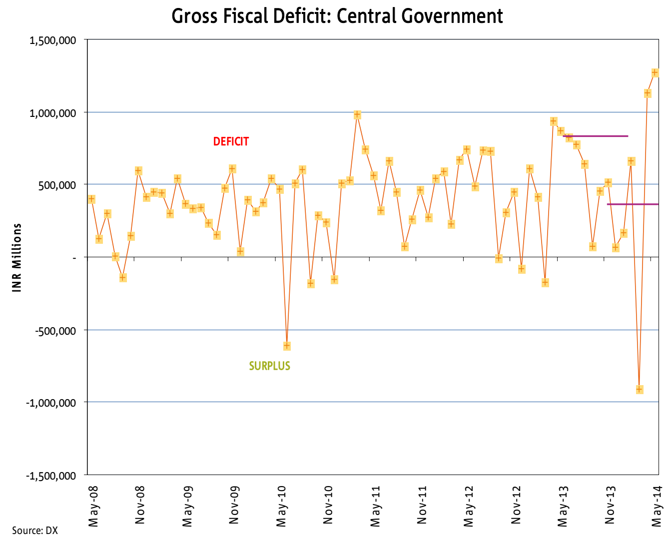


Figure 2: Monthly Deficit Indicators



Taxation & States

- The Government has focussed firmly on boosting household disposable income in this Budget. The objective here is to increase household savings (thereby reducing the reliance on foreign savings, and limiting the Current account deficit), as well as providing a fillip to consumption, particularly for lower- middle income households.

- The Government also wishes to improve the Business Environment in India, which was sullied by retrospective taxation cases brought on companies such as Vodafone. These measures have damaged India's business reputation, and the Government had made an attempt to address this.

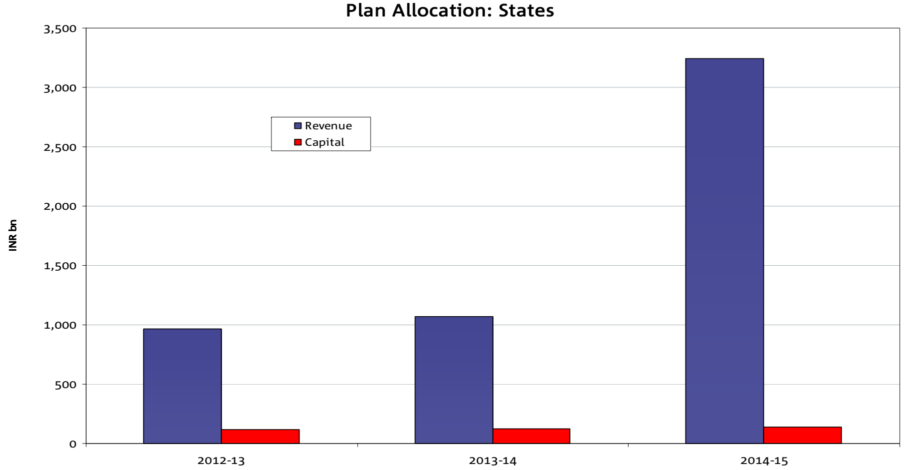
- Another significant features of this Budget is the increased funding (and added service responsibility) for the States. The Current Government believes that States are better placed than the Centre to provide a number of services, and so there has been an almost doubling of the funding allocation towards the States.

- **Implications:** The Budgetary initiatives should broadly be supportive of increased household consumption and savings. Measures to address the issue of retrospective taxation are a welcome first step, although there still remains some uncertainty. Finally, the decision to boost funding to the States should benefit some of the more developed States; conversely, some of the less developed States may struggle to provide the level of services expected.

Table 1: Taxation Measures

Issue	Measures adopted
Personal Tax rates	Income tax-exemption limited raised by Rs 50,000.
Section 80C Deduction	The investment limit for deductions under Section 80C of the Income Tax Act has been raised by Rs 50,000.
Public Provident Fund	The annual ceiling in the public provident fund scheme too was raised by Rs 50,000.
Excise duty on Footwear	Reduced from 12% to 6% for footwear costing more than INR 500, up to INR 1,000 per pair, to boost spending by lower-middle income earners.
LCD & LED TV Panels	To increase production of LCD & LED Televisions below 19 inches, the basic customs duty of 10% has been abolished.
Cigarettes and Tobacco	Will incur higher excise duties, up to 72%for certain types of cigarettes.
Advance Rulings	In relation to indirect taxes, domestic companies can now avail of this facility for tax planning purposes.
Retrospective Taxation	Will not 'ordinarily' bring in retrospective taxes. Current cases (e.g. Vodafone) to be reviewed by a High level panel.

Figure 3: State Funding Allocation



Source: Union Budget

Real Estate

- The real estate sector has been one of the major beneficiaries of the current Budget.
- This includes measures such as higher interest deductibility for owner occupied housing, which should spur demand for residential property, helping the beleaguered sector.
- The focus on smart cities and lower FDI hurdle requirements should encourage greater urbanisation. Increased foreign participation in domestic construction will enable smaller domestic players to engage with foreign operators in a joint venture type arrangement to develop projects.
- Finally, the introduction of REITs could add liquidity, pricing transparency and depth to the real estate market. It will assist property developers to access new sources of funding, as well as help non-property companies with large real estate holdings to monetise them.
- **Implications:** The Budget measures should be supportive both for developers as well as financial firms able to design REIT-type products.

Table 2: Real Estate Initiatives

Issue	Measures adopted
Housing Loan interest exemption	For owner-occupied houses, the housing loan interest exemption has been raised from INR 150,000 to INR 200,000.
REITs	Development of Real Estate Investment trusts (REITs) with tax pass through status.
Smart Cities	A commitment to develop 100 'smart cities' with an allocation of INR70.60 BILLION.
Lower FDI hurdles	To ensure the efficacy of the above, the hurdles for FDI in real estate have been eased. The build up area for FD in real estate has been reduced from 50,000 sq. metres to 20,000 sq. metres, and the minimum capital requirement halved to $5 million.
Low Cost housing	INR 120bn allocated to National Housing Bank for low-cost housing initiatives in urban and rural areas.

Infrastructure

- The infrastructure sector, like Real Estate, has been a major beneficiary of this Budget. The Budget recognises some of the weakness in India's infrastructure, and addresses some of these issues. Put another way, it is focussing on improving the supply side.

- By focussing on infrastructure related activity such as roadworks, not only is the stock of infrastructure likely to improve, but the activity is likely to support ancillary activity across the infrastructure supply chain (e.g. cement manufacturers), generating growth and employment opportunities.

- The focus on finance, both from Banks as well as Investment trusts is highly relevant, although the details would need to be worked out carefully on a case by case basis, given the large sums and lead times involved in large-scale infrastructure projects.

- **Implications:** The budget has provided opportunities for companies in the heavy engineering, procurement, construction, capital goods, cement and logistics sectors. There is clearly one key objective in mind: boosting the capital investment cycle which has been very weak of late.

Table 3: Infrastructure Initiatives

Issue	Measures adopted
Roads & Highways	Allocation of INR378bn to National Highways Authority of India for roads and INR 140 bn for rural roads.
Shipping	INR 116.35 for the development of Outer Harbour Project in Tuticorin for Phase 1..
Inland Water	Allocation of INR 42bn for Inland Waterways in the Ganges to facilitate commercial shipping for vessels up to 1,500 tonnes.
Ultra Mega Solar Projects	INR 5bn for the development of Ultra Mega solar power projects in Rajasthan, Gujarat, Tamil Nadu, Andhra Pradesh and Ladakh.
Price Stabilization Fund	INR 5bn to mitigate against agricultural price volatility.
InvITs	The creation of Infrastructure Investment Trusts (InvITs), which would have tax-efficient pass through status for PPPs and other infrastructure projects.
Banking Initiatives	Encouraging banks to extend long term loans for infrastructure, as well as raising funds, whilst being exempt of restrictions such as CRR, SLR and Priority sector lending.
National Industrial Corridor Initiative	A national Industrial corridor Authority is expected to be set up at a cost of INR 1 bn to co-ordinate the development of industrial corridors.
Customs Clearance	Creation of a single-window customs clearance at Indian ports.

Manufacturing & Training

- The Government has placed a strong emphasis on boosting the underperforming manufacturing sector.
- This is one of the strategies of the newly elected administration to increase employment opportunities, with around 70% of India' population below the age of 35.
- In addition to creating a venture capital fund to boost entrepreneurship, the Government is aiming to foster a more entrepreneur friendly climate by aiming to alter the bankruptcy framework.
- Further, there are measures aimed at boosting Textiles and IT, sectors which traditionally figure strongly in India's export mix.
- Finally, there have been initiatives to improve training and development in the areas of engineering, medicine and management.
- **Implications:** There is a clear strategy by the Government to improve India's manufacturing and entrepreneurial capability, which would assist in raising India's growth potential – provided the measures are well-executed. The focus on training is good, as it would enable India to move into more value-added manufacturing activities. The question is whether these new Institutions (e.g. IITs, IIMs) would be able to match up to the standard of existing facilities.

Table 4: Manufacturing Initiatives

Issue	Measures adopted
SME Venture Fund	A 100 bn Venture Capital Fund to promote entrepreneurship among SMEs.
Technology Centre Network	INR 2bn to help establish a Technology Centre Network to promote, innovation, entrepreneurship and agro-industry.
Bankruptcy Framework	Create entrepreneur friendly legal bankruptcy framework with easy exit, so as to encourage innovation.
Textile Mega Cluster	INR 5bn to set up a Textile mega-cluster at Varanasi as well as in other locations such as Lucknow and Mysore.
E-Commerce	Setting up E-Commerce Platforms for manufacturers to sell directly without additional charges.
Capital Allowance	15% tax Allowance for Corporations undertaking capital investment totalling INR 250 million, and above.

Table 5: Training Initiatives

Issue	Measures adopted
IIT'S	Setting up INR 5bn for the establishment of 5 new IIT (Indian Institute of Technology) to promote engineering excellence.
IIMs	Allocation of INR 5 bn for the creation of 5 new IIMs (Indian Institute of Management) to enhance managerial capability.
Digital India	Setting INR 5bn for a pan-India initiative to boost digital connectivity, and support software start-ups.
AIMS	Allocation of INR40bn for setting up 4 more All India Institute of Medical Sciences (AIIMS).
MNREGA	Linking rural employment initiative with productivity.

FDI & Portfolio Investment

- The Budget has aimed to enhance India's attraction as a destination for overseas investment.

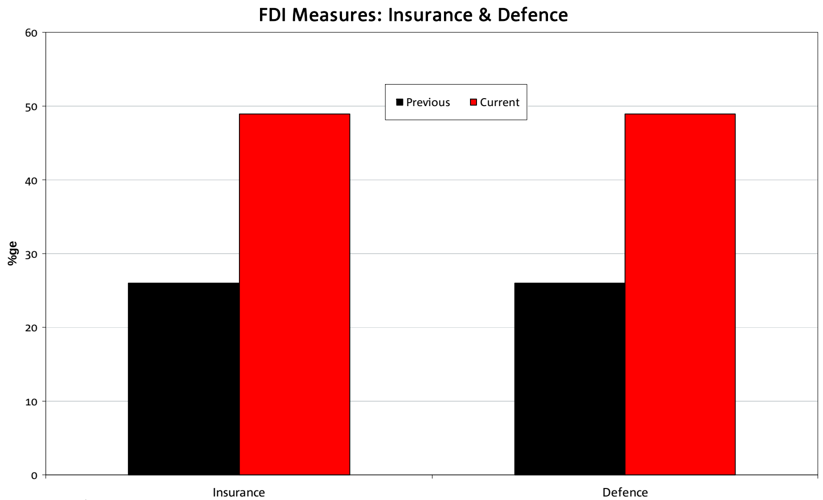
- As part of the above measures, the Government has proposed to increase the FDI limit in Insurance and Defence from 26% to 49%. This would enable greater insurance penetration, and allow Indian operators to tie up with large global insurance providers.

- In fact, the *Economic Times*, has indicated that as much as USD3bn could flow into India as a result of the changes to Insurance.

- The Government has also provided greater clarity regarding Foreign portfolio income. They are to be treated as Capital gains for tax purpose, and not business income. This could spur further inflows into Indian financial markets. Moreover, it could encourage some Institutions to shift operations to India, improving India's financial sector in the process.

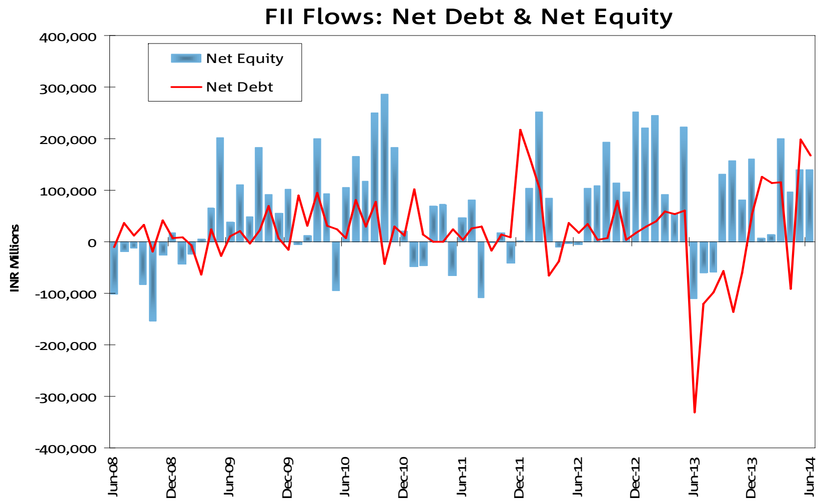
- **Implications:** The FDI measures will most likely result in increase overseas investment in India. That said, the issue of defence technology transfer could be tricky, to say the least. Further, the clarity on taxation for Foreign Portfolio investors would increase the attractiveness of investing in India, and could also lead to some operators relocating to India, benefiting India's finance industry in the process.

Figure 4: FDI Changes



Source: Union Budget

Figure 5: Portfolio Inflows



Source: DX

Financial Market Impacts

- The Budget was somewhat underwhelming from a financial markets perspective, with equity indexes declining about 0.3%. This, in part, reflects very high market expectations, particularly with regard to issues such as the launch of a possible GST.
- Since then, economic and political events – both local and global – have influenced the markets. Indian equity markets have moved higher on global cues, strong FII interest, as well as a very strong showing from sectors such as IT, with Infosys having recently signed a multi-year agreement to manage data services for German auto giant, Daimler.

- The INR has been broadly steady around INR 60/USD. Moreover, Equity market volatility seems to have eased quite considerably, post elections.
- To sum up, the markets have moved on from the Budget, and are firmly focussed on local and global economic and financial indicators.

Figure 6: Equity Market

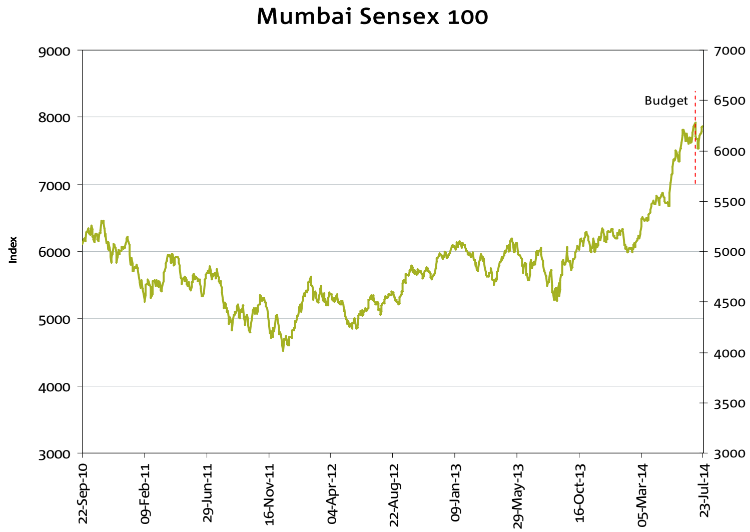


Figure 8: Equity Volatility

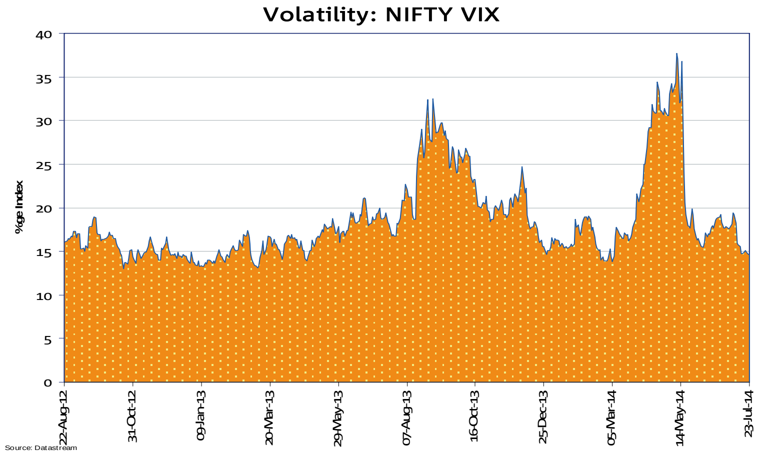
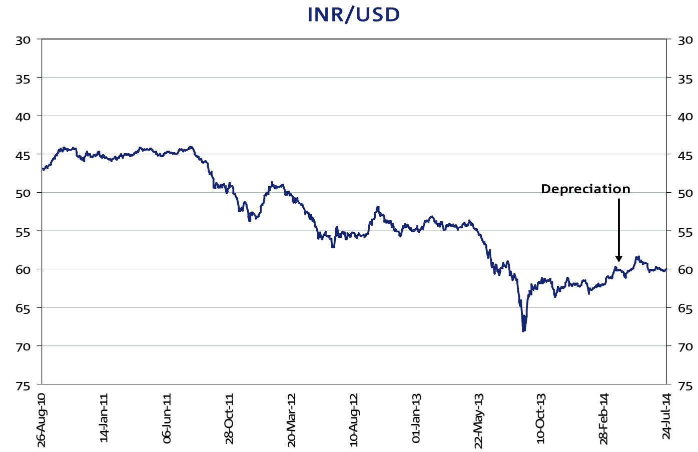


Figure 7: INR/USD



Economic Outlook

- The Government's Economic Survey, released prior to the Budget forecasted growth between 5.4%-5.9% over the 201-15 financial year. It highlighted risks were titled towards the lower end of the forecast band.
- Following the release of the Budget, NAB Economics has maintained its forecast of 5.2% in 2014, followed by 5.8% in 2015.
- We are encouraged by some of the measures contained in the Budget with regard to boosting infrastructure, manufacturing and rising disposable incomes among consumers. However, we remain concerned about possible implementation risks, the impact of the drought, and possible detrimental effect of high oil prices stemming from geopolitical risks.
- Other issues relate to the overly optimistic Fiscal deficit projections, and timelines for implementing important measures such as the GST.
- As such, this Budget is a welcome first step as part of the **process** of improving India's economic, fiscal and business environment. Effective implementation and additional follow up measures are critical to raise India's growth potential.

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