



## **Union Budget 2009-10: The Balancing Act Ahead**

The Union Budget for 2009-10 will soon be presented by the newly-formed Government at the Centre against a backdrop of relative stability on the domestic political front and continuing economic uncertainty in the global arena. While the expectations are enormous, so are the challenges, given that further counter-cyclical measures seeking to stimulate economic growth will have to be weighed against their impact on the fiscal balances in the light of the burgeoning fiscal deficit and the large borrowing programme that Government of India (GoI) has projected for 2009-10 in its Interim Budget.

The jury is still out on the extent of recovery that has taken place in the real economy since the lows reached in the last quarter of 2008-09. Nevertheless, there could be a case for providing further stimulus to the economy, through a combination of measures that translate into additional expenditure in the infrastructure and social sectors and policy-level measures that are perceived as pro-reform and therefore holding the potential to favourably impact sentiments of a wide range of market participants—in the process promoting private consumption as well as investments.

The other challenges facing the policymakers include maintaining a reasonable interest rate regime (to stimulate growth) in the likely scenario of high Government borrowings putting a strain on yields and inflationary pressures building up in the second half of the fiscal year. While headline wholesale price inflation (WPI) has entered negative territory despite food price inflation remaining high, WPI is expected to rise in the near to medium term as the base effect turns adverse and commodity prices trace an upward path, taking the cue from a likely demand revival and an accommodative monetary policy globally.

### **Government's policy on reforms would be keenly awaited**

The reforms-oriented stance and the priorities outlined by the coalition Government soon after assuming office have pushed up expectations significantly. Investors and market participants would be looking at Budget 2009-10 closely for firm indications on the Government's reforms agenda, particularly in areas such as foreign direct investment, disinvestment, petroleum price deregulation, and treatment of off-budget items such as oil/fertiliser bonds. Also of considerable interest would be proposals to raise revenues through alternative routes such as disinvestment and auction of 3G spectrum; the indicative structure for the proposed Goods and Services Tax and the timing of payment of arrears (next instalment) as per the Sixth Pay Commission report.

### **Reviving growth in manufacturing would be critical, but scope for further stimulus through lower taxes appears limited**

The three stimulus packages that were announced in the latter half of 2008-09 contained a number of measures aimed specifically at the manufacturing sector. While some sub-sectors within manufacturing have shown signs of recovery since then, many export-oriented sectors, which are also labour intensive, are still reeling under the impact of the global slowdown. However, GoI's ability to formulate further indirect taxation measures for these appears limited, given the fiscal position. In fact, the constrained fiscal situation may compel GoI to withdraw tax cuts already imposed, especially for sectors which have been affected to a lesser degree. Also the current CENVAT rates are likely to be inconsistent with the rates under the proposed Goods and Services Tax (GST). Sectors which would be adversely impacted in case of a roll back of the excise duty cuts include automobiles, steel and consumer durables. Nevertheless, it is likely that some relief measures, like interest subvention on export credit, may be continued.

## **In any case, increasing Governmental expenditure may be a more desirable option**

While the impact of tax cuts and that of higher expenditures on the fiscal balances of the Union Government would be broadly similar, ICRA sees the Indian economy as deriving greater benefits from higher expenditure on the social and infrastructure sectors than from measures like tax cuts. This is assuming that the increased governmental expenditures, however, are better targeted, leakages minimised, and speed of project implementation increased significantly. The view is based on the reading that the consumption-stimulating potential of tax cuts would be limited, given that a significant section of taxpayers' marginal propensity to consume would also be impacted by the benefits flowing from the implementation of the Sixth Pay Commission's recommendations by the Central and State Governments.

## **Infrastructure likely to be a key focus area...**

A key focus area for Gol in the forthcoming Budget is likely to be infrastructure, which is widely recognised as the biggest constraint to achieving India's growth potential. Apart from power, the pace of project implementation has slackened considerably in other infrastructure areas. While several of the constraints to faster infrastructure development may be beyond the purview of the Budget, the policy announcements made in this area would be of considerable significance. The key issues that require attention include: establishment of an empowered regulator for some of the key areas within the infrastructure sector; streamlining of the Viability Gap Funding mechanism for areas like roads and highways, and devising of practical ways to push for implementation of projects on Public Private Partnership (PPP) basis.

There could also be a case for more fast-track mission-mode initiatives in line with the JNNURM<sup>1</sup> for the rest of the cities in India. Notwithstanding another scheme, Urban Infrastructure Development Scheme for Small and Medium Towns (UIDSSMT), launched in the past for small and medium cities, many more urban areas need to be covered.

Given the need for additional energy security, another area where reforms are overdue is in the area of enabling private sector participation in coal mining. The policy objectives in the case of coal mining could include more objectivity in the grant of mining licences, faster environmental and forestry clearance, and greater transparency in coal pricing.

## **...And so would be making funds available for the sector**

Policy and regulatory issues apart, a key constraint for the infrastructure sector that Budget 2009-10 could address is availability of adequate funds. Over the last few months, project implementation in the sector has been severely impacted by delays in achieving financial closure. As part of its stimulus packages, Gol had authorised India Infrastructure Finance Company Limited (IIFCL) to raise, by March 2009, Rs. 10,000 crore through tax-free bonds. More such steps would be necessary for facilitating fund flow to this sector, including availability of sufficiently long tenure financing options and relaxing the exposure norms for infrastructure projects. A common wish list is also the reintroduction of tax breaks for infrastructure financing for reducing the cost of funds.

## **Implementation of GST awaits Budgetary direction**

With less than a year to go before the announced rollout of the proposed GST, it is expected that the Union Budget for 2009-10 will provide an indicative structure for the same. In this regard, the issues that would need to be addressed include the nature of GST, that is, whether single or dual; the proposed rate structure; the compensation mechanism for the States; and the legal changes required before GST can be introduced. These apart, the question of whether April 1, 2010 is a realistic date for migration to a new GST regime remains unresolved, given the doubts recently expressed by certain States regarding their readiness for the same.

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<sup>1</sup> Jawaharlal Nehru National Urban Renewal Mission

## **Expectations run high on other tax measures as well**

Expectations are high on quite a few other tax related issues as well, such as abolition of Fringe Benefit Tax, extension of tax holidays for the IT and ITES sector, extension in the period for which 80IA benefits are available for infrastructure sectors, tax holiday on production of natural gas from NELP blocks, tax break for construction of low cost housing, and rationalisation of Dividend Distribution Tax. Other specific sectors which are looking for a rationalisation of the tax structure include fast moving consumer goods, cement, automobiles and telecom.

## **Trajectory on the Centre's fiscal consolidation to be laid out**

The negative impact of the ongoing economic slowdown on revenues and the consequent counter-cyclical measures undertaken by GoI have contributed to a sharp deterioration in its revenue balance and fiscal deficit, with respect to the targets laid out under the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. Although GoI has mandated the Thirteenth Finance Commission (expected to submit its report later this year) to review the fiscal situation and propose a modified fiscal adjustment path for the period 2010 to 2015, nevertheless, the level of deficits proposed in the 2009-10 Budget for the subsequent two years will indicate the Government's expectation on how rapidly it will be able to return to a fiscally sustainable path.

Besides the revenue and fiscal deficit, the Budget will be scrutinised for the borrowing requirement projected for 2009-10 and its consequent implications for bond yields and overall interest rates. Fears that the Budget would likely indicate an enlarged Government borrowing programme have kept bond yields high despite the rate cuts introduced by the Reserve Bank of India since mid-September 2008.

## **Budget expected to provide a direction to fiscal planning at the State Level**

The Union Budget 2009-10 is expected to have significant implications for the finances of the State Governments. The cumulative effect of tax measures introduced by GoI will determine the amount of tax revenues devolved by it to the States, and thereby impact the revenue collections and fiscal balances of the latter. The economic slowdown which started in the latter half of 2008-09 had a negative impact on the growth of devolved Central tax revenues as well as own revenue collections in 2008-09 for several State Governments. To help the States tide over this slowdown, GoI had previously relaxed the requirement for elimination of revenue deficit, and allowed the States to incur a fiscal deficit of up to 3.5% of Gross State Domestic Product (GSDP)<sup>2</sup> in 2008-09 and 2009-10, while maintaining their eligibility to receive the benefits under the Debt Consolidation and Relief Facility. Any further relaxation of the fiscal targets announced by GoI will impact fiscal planning at the State level in the near term, whereas the recommendations of the Thirteenth Finance Commission, the proposed migration to GST and higher expenditures incurred on account of the Sixth Pay Commission's recommendations are likely to be key factors impacting the health of States' finances in the medium term.

## **Conclusion**

Overall, the Union Budget for 2009-10 is expected to provide a thrust to spending in the infrastructure as well as social sectors, and selectively rationalise taxes, while at the same time ensuring that the fiscal deficit does not slip significantly below the level indicated in the Interim Budget. While fiscal consolidation in the current year itself may be difficult given the present environment, demonstrating commitment towards fiscal sustainability would be critical, at both the Central and the State level. In addition, while the Government has provided some indications regarding the reforms agenda that it intends to pursue, the Budget is expected to set the tone regarding the implementation of the same.

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<sup>2</sup> As compared with the earlier requirement of curtailing fiscal deficit to 3% of GSDP

*For further details please contact:*

Analyst Contacts:

**Ms. Aditi Nayar**, (Tel. No. +91-124-4545385)  
*aditin@icraindia.com*

Analyst Contacts:

**Mr. Anjan Ghosh**, (Tel. No. +91-22-30470006)  
*aghosh@icraindia.com*



## ICRA Limited

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### CORPORATE OFFICE

Building No. 8, 2nd Floor, Tower A, DLF Cyber City, Phase II, Gurgaon – 122002  
Tel.: +(91 124) 4545 300; Fax: +(91 124) 4545 350

### REGISTERED OFFICE

Kailash Building, 11th Floor 26, Kasturba Gandhi Marg, New Delhi 110001  
Tel.: +(91 11) 2335 7940-50; Fax: +(91 11) 2335 7014, 2335 5293  
Email: [info@icraindia.com](mailto:info@icraindia.com) Website: [www.icra.in](http://www.icra.in)

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Branches: **Mumbai:** Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 □ **Chennai:** Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 □ **Kolkata:** Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 □ **Bangalore:** Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 □ **Ahmedabad:** Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 □ **Hyderabad:** Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 □ **Pune:** Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 553 9231

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