



Union Budget, 2010-11: Fiscal Consolidation likely to be the Priority

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The Union Budget for 2010-11, which will be presented shortly by the Government of India (GoI), is likely to signal a shift in fiscal policy from stimulating growth to fiscal consolidation. With economic growth having recovered substantially in recent months, GoI is likely to revert to fiscal prudence so as to undo the deterioration witnessed in its fiscal performance in 2008-09 and 2009-10 against the backdrop of the global economic crisis. ICRA's key expectations from the Union Budget are a) laying down a road map for reversing the various tax cuts to boost revenue receipts b) providing for higher social sector spending in a prioritised manner so as control growth in revenue expenditure c) some announcements on the widely expected reforms in the area of subsidies even if not sweeping in nature, and clarity on issues related to the goods and services tax (GST) and the direct tax code, and d) thrust on augmenting infrastructure, both physical and social.

A combination of higher expenditure committed by GoI prior to the economic slowdown, counter-cyclical revenue and expenditure measures instituted as part of the fiscal stimulus packages, and a cyclical slowdown in growth of tax revenues mirroring the economic scenario, led to a substantial deterioration in GoI's revenue and fiscal balances during 2008-09 and 2009-10. The higher expenditure committed prior to the economic crisis included the Pay Commission related benefits and the Debt Waiver to Farmers, which however also acted as stimulants for economic growth. Additionally, GoI introduced a number of fiscal stimulus packages in 2008-09 that entailed higher expenditures and tax cuts to stem the slowdown in economic growth, but these led to considerable departure from the targets set in the Fiscal Responsibility and Budget Management Act, 2003 (FRBM) in 2008-09 and 2009-10.¹

Table 1: Trends in Fiscal Indicators (as a Percentage of GDP)

	2006-07	2007-08	2008-09 RE	2009-10 BE
Revenue Receipts	10.1%	11.0%	10.1%	10.0%
Revenue Expenditures	12.0%	12.0%	14.4%	14.6%
Revenue Balance	-1.9%	-1.1%	-4.3%	-4.6%
Capital Receipts	0.0%	0.8%	0.0%	0.0%
Capital Expenditure & Net Lending	1.5%	2.3%	1.6%	1.9%
Fiscal Deficit	-3.3%	-2.6%	-5.9%	-6.5%

Source: GoI Budget Documents, ICRA Estimates

BE: Budget Estimate, RE: Revised Estimate

The recent data point to a strong revival in economic growth. GDP growth for the second quarter (Q2), 2009-10 rose to 7.9% and advanced estimates released by the Central Statistical Organisation (CSO) suggest that economic growth will improve to 7.2% in 2009-10 from 6.7% in 2008-09.

¹ The FRBM envisaged the revenue account being balanced and the fiscal deficit being restricted to 3% of gross domestic product (GDP) from 2008-09 onwards

Monthly industrial growth trends provided by the Index of Industrial Production (IIP) too point towards a persistent improvement in industrial growth in recent months, albeit somewhat uneven and benefitting from a benign base effect, with the IIP expanding by 16.8% in year-on-year (y-o-y) terms in December 2009. With growth largely back on track, it is appropriate for Gol to now shift its focus back to fiscal prudence. The rolling targets included in the Medium Term Fiscal Policy (MTFP) Statement published with the Union Budget for 2009-10 suggested that the revenue and fiscal deficits would be brought down to 3% and 5.5% of GDP respectively, in 2010-11, which is likely to require a phased rollback of the previously instituted tax cuts, besides substantial control on expenditure growth.

Indirect tax collections to be determined by the timing and phasing of reversal in tax cuts

The fiscal stimulus packages announced in 2008-09 included measures relating to indirect taxes such as a reduction in excise duty by 4% to 6%, a cut in service tax by 2%, elimination of import duty on specific goods, and refund of various taxes to exporters. The cuts in excise duty in particular, helped avert a deep and protracted economic slowdown by stimulating consumer demand and thereby economic growth: available quarterly data suggests that manufacturing growth rebounded to 9.2% in the second quarter (Q2) of 2009-10, after having remained in the range of -1.4% to 3.4% in the preceding three quarters.

Expectedly, these measures had an adverse impact on revenue growth and the overall fiscal balances of Gol. Growth of indirect tax collections slowed significantly in 2008-09 and has languished in 2009-10, being hit by the combination of tax cuts, economic slowdown since the second half of the previous fiscal year, and sharp reduction in import volumes. With collections likely to miss the target set for the current fiscal year, the revenue deficit may exceed the Budget Estimates.

While recent data point to a revival in economic growth, disaggregated IIP growth trends suggest that the economic recovery is not sufficiently broad based across sectors, raising the concern that the withdrawal of the tax cuts at this juncture may have a somewhat dampening effect on consumer demand for products with a relatively high price-sensitivity. Besides, the pass-through into higher prices may also exert some upward pressure on inflation.

Notwithstanding lingering concerns over the sustainability of growth, ICRA feels that a reversal of the tax cuts may be inevitable, to effect a significant reduction in the revenue deficit in 2010-11. However, the magnitude of the rollbacks as well as their timing and sequencing need to be carefully calibrated to ensure that the growth revival does not lose steam. Thus Union Budget, 2010-11, could announce a roadmap for the phased withdrawal of the tax cuts to limit the negative impact on growth. The possible options could be expanding the base on which service tax is levied, a marginal increase in the rate of service tax and excise tax and further increases after additional data confirm the strength of the economic recovery and of corporate profitability (in 2009-10). Additionally, the reversal in excise cuts could be calibrated to specific sectors which have witnessed a substantial pick-up in demand, for instance the auto and consumer durables sectors.

In addition to revenue augmentation, reversal in the cuts in excise and services taxes may also be required in view of the need to align these rates with the rates of the proposed GST.

Direct tax rates unlikely to be changed substantially

Mirroring the slowdown in economic growth, growth of direct tax collections slowed substantially in 2008-09 and clocked a low 8.5% growth in April-December 2009. With collections at Rs. 2.5 trillion at the end of December 2009, the 2009-10 Budget Estimate of Rs. 3.7 trillion is likely to be met although collections may fall substantially short of the revised target of Rs. 4 trillion. In view of the new direct taxes code to be implemented with effect from April 1, 2011, Budget 2010-11 is unlikely to introduce any major changes with regards to direct taxes. As a result, the pace of direct tax collections in 2010-11 would hinge on the strength and sustainability of the economic recovery now being witnessed and the profitability of the Indian corporate sector.

Net tax receipts to reflect Finance Commission's recommendations for tax sharing

The recommendations of the Thirteenth Finance Commission, whose report is to be tabled in Parliament on February 25, 2010, will determine the proportion of Central tax revenues to be shared with the Indian States over the years between 2010-11 and 2014-15. With the Twelfth Finance Commission having increased the proportion of shared taxes to 30.5% from 29.5% during the Eleventh Finance Commission period, there is a high likelihood that the share would be revised further upwards by the present Commission. This in turn would impact the net tax revenues collections of Gol.

Receipts to get a boost from 3G auction and disinvestment proceeds

The Budget Estimate for 2009-10 for non-tax revenues had estimated receipt of Rs. 350 billion from the auction of 3G spectrum in 2009-10. But with the auction having been delayed, in the event that the proceeds from the auction are not received in the ongoing fiscal year, non-tax revenue receipts would be considerably lower than the budget estimate, which would place significant pressure on Gol's revenue balance. However, if the auction takes place in 2010-11, the one-time proceeds from would reduce the burden on the revenue deficit in the coming fiscal year.

As for disinvestment proceeds, these are likely to substantially exceed the targeted Rs. 11.2 billion in 2009-10 (considering the three issues that have already hit the capital markets), thereby easing the pressure on the fiscal deficit to an extent in the current fiscal year. With an active disinvestment plan being proposed, Gol is likely to set a higher target for capital receipts in 2010-11. Nevertheless, the size of the same in relation to the fiscal deficit is likely to remain small. Also, regardless of the Budget Estimate for 2010-11, the magnitude of resources raised through disinvestment will depend on the overall market sentiment, timing and number of issues and the valuation levels.

Revenue expenditure growth likely to be controlled by prioritising enhancement of outlays

While revenue growth is expected to accelerate in 2010-11, reflecting both the anticipated rollback of tax cuts as well as buoyant direct tax collections, and savings are expected from the absorption of liabilities such as the Pay Commission related arrears, a controlled growth of revenue expenditure would be necessary to achieve any substantial improvement in the revenue balance in 2010-11.

On the positive side, the impact of the Pay Commission related arrears on revenue expenditure has been absorbed in 2008-09 and 2009-10 and the magnitude of expenditure towards the debt waiver for farmers is also expected to shrink in 2010-11 in relation to 2009-10. Additionally, it is likely that expenditure on the Mahatma Gandhi Rural Employment Guarantee Scheme may be lower in 2010-11 as compared to the ongoing fiscal year, on the back of a normal monsoon and enhanced employment opportunities in the farm and non-farm sectors. All this may provide some fiscal space to incur additional expenditure.

However, lower expenditure on account of the above is likely to be offset by an increase in spending on social sector schemes, food subsidies etc., in line with the Government's stated policy of inclusive growth as well as higher plan and non plan devolution of grants to the State Governments. The implementation of the scheme to provide 25 kg of wheat or rice per month at Rs. 3 a kg to all BPL² families would necessitate an enhanced outlay for food subsidy in 2010-11. In addition, the trend of annual increases in the Minimum Support Prices (MSP) would further increase expenditure towards the administration of the public distribution system (PDS). Thus ICRA feels that in order to contain the revenue deficit to 3% of GDP in 2010-11 as suggested by rolling indicators included in 2009-10 budget, any increase in budgeted outlays would need to be prioritised between various sectors and schemes. For instance, an attempt could be made to consolidate schemes, in order to decrease administrative expenditures and improve operating efficiency.

Additionally, the recommendations of the Thirteenth Finance Commission on the level of non-Plan grants proposed over the next five-year period will have a substantial bearing on the Centre's expenditures over the medium term. Enhancement of outlays for Plan grants to the States in 2010-11 would be critical to encourage infrastructure creation at the State level.

Infrastructure to remain a focus area with higher outlays and measures to accelerate implementation

It is widely expected that the Union Budget for 2010-11 will focus in a big way on infrastructure creation, both physical and social, through higher budgetary allocations as well as facilitative policy measures in areas like promoting Public Private Partnership. With higher disinvestment proceeds likely to be targeted, there would be substantial headroom to increase the level of capital expenditure in 2010-11, which would result in enhanced outlays for infrastructure. Expanding the scope of activities of the India Infrastructure Finance Company Limited (IIFCL), financial sector reforms aimed at development of a corporate bond market, and fiscal measures designed to augment the availability of long term funds for infrastructure projects are other areas where some positive steps are expected.

² Below poverty line

Additionally, steps to accelerate the implementation of infrastructure projects, such as the plan to improve the pace of construction of highways to 20 km per day and expedite the commissioning of power plants to address India's growing power deficit are crucial to improve infrastructure availability in the face of rising demand. Moreover, additions to infrastructure would create a more conducive business environment and lower the constraints to growth, thereby acting as a stimulant for higher economic growth.

The magnitude of investments in infrastructure and the rate of implementation of projects are likely to remain crucial determinants of the pace of economic growth in 2010-11, particularly in view of the likely diminishing contribution of consumption-led growth, and until private investment gathers pace. Moreover, given the infrastructural deficit in India, higher investments in this sector would improve the country's long-term growth prospects.

Expectations run high in the area of structural reforms

Structural reforms, which would not only help in improving the fiscal position, but also send out a favourable signal to investors and other market participants, would be another key area for the budget this year. Leading the list would be a roadmap for the implementation of the Kirit Parikh committee's recommendations on oil pricing, decontrol of fertiliser prices and clarity on fertiliser pricing under the nutrient based regime as well as the timeline for implementing the same. Additionally, measures to reduce leakages by way of changing the method of delivery of subsidies through smart cards or conditional cash transfers could be introduced. It is hoped that reforms in these areas will considerably reduce the burden of subsidies while simultaneously allowing better targeting, so that over the long term they are more sustainable.

With hope fading for the introduction of GST on April 1, 2010, the Union Budget for 2010-11 is expected to provide some clarity on when GST would be introduced, as well as on other issues including the proposed rates at the Central and State levels, the threshold for registration of dealers, the items that would be exempted from this levy and additional goods and particularly services on which GST would be levied. The expected lower incidence of tax rates after the migration to GST would increase disposable income, thereby stimulating demand and providing an impetus to continued consumer spending. Additionally, while GST is expected to be revenue neutral given the anticipated expansion in the tax base, the compensation package for losses that may accrue to the State Governments because of administrative issues is awaited.

Clarity on operational and legal issues related to the Direct Tax Code is also expected in view of creating a stable tax environment and allowing corporate entities to plan their investments. Proposals related to enhancement of the tax base and minimising exemptions would result in a higher level of revenue receipts for the Centre and State Governments, while the proposed rationalisation of direct taxes would improve compliance.

Reaffirmed commitment to fiscal consolidation expected; new medium term fiscal trajectory awaited

The medium term fiscal consolidation programme for the Central and State Governments over the next five year period is expected to reflect the recommendations of the Thirteenth Finance Commission. It is expected that Gol will retain the rolling targets for 2010-11 published in the 2009-10 Budget, although restricting the revenue deficit to 3% of GDP is likely to require considerable resolve to control the growth of revenue expenditure. GDP estimates calculated as per the new base year of 2004-05, which were recently released, resulted in an upward revision of the series. As a result of this, deficits as a percentage of GDP in 2008-09 and 2009-10 will be lower. This will also provide some amount of headroom in 2010-11 by allowing Gol to incur higher deficits in nominal terms while sticking to the aforementioned targets relative to GDP.

While the target for 2010-11 is of great interest, the medium term milestone will indicate the extent of fiscal correction envisaged and help in ascertaining whether the higher expenditure growth in recent years has caused a structural deterioration in Gol's finances. Whether the proposed MTFP suggested by the Thirteenth Finance Commission will incorporate a cyclically-adjusted approach to deficits is awaited, which would allow for revenue deficits and higher fiscal deficits in years of low growth and revenue surpluses and lower fiscal deficits in years of high economic growth, thus enabling the Government to use counter-cyclical fiscal policy to stimulate growth during economic downturns.

Gol allowed the States to incur a revenue deficit and restrict the fiscal deficit to 3.5% of gross state domestic product (GSDP) in 2008-09 and 4% of GSDP in 2009-10, as compared to the Twelfth Finance Commission's target of restricting the latter to 3% of GSDP from 2008-09 onwards, in the wake of the economic slowdown in 2008-09. While revenue growth is expected to recover in 2010-11, expenditure

growth is likely to remain high, particularly on account of higher pay scales and release of a portion of arrears related to the Pay Commission in a number of States, and several States may find it difficult to achieve a surplus on the revenue account in the coming fiscal year. The level of fiscal deficit that the State Governments are allowed to incur in 2010-11 will crucially impact the magnitude of capital expenditure that the States will be able to undertake.

In addition to the estimated level of the fiscal deficits of Gol and the State Governments, the magnitude of below-the-line items including bonds issued to Oil and Fertiliser companies will determine the consolidated fiscal deficit (CFD). The volume of bonds issued increased to Rs. 959.4 billion as per revised estimates for 2008-09 (1.7% of GDP) from Rs. 280.5 billion in 2007-08 (0.6% of GDP), reflecting the increase in crude oil prices, and exerted considerable additional stress on the CFD. A concerted attempt should be made in 2010-11 to restrict the consolidated deficit below 10% of GDP, through reducing the fiscal deficit targets for the Central and State Governments as well as employing measures to reduce the incidence of subsidies so as to cap the level of bond issuances required going forward.

Magnitude of Government borrowing likely to remain substantial

In 2009-10, the large borrowing programmes of Gol and the State Governments could be managed, albeit with hardening yields, because of low credit off-take, comfortable liquidity conditions, de-sequestering of the proceeds from the earlier sale of market stabilisation scheme (MSS) bonds, and infusion of additional liquidity through open market operations. Simultaneously, the financing requirements of the private sector were met through a host of non-bank sources, including private placement of debt, qualified institutional placements, and external commercial borrowings.

Despite the fiscal consolidation that may be attempted in the Union Budget for 2010-11, Gol's fiscal deficit is likely to remain nearly as high as it was in 2009-10 in nominal terms. The Government borrowing programme therefore is likely to be substantial in 2010-11. With the recent hike in the cash reserve ratio (CRR), the volume of Government borrowing to be undertaken would strain liquidity conditions, and result in an upward pressure on bond yields and interest rates.

With substantial inflationary pressures expected at least through the early months of 2010-11, the Reserve Bank of India (RBI) is unlikely to infuse additional liquidity through open market operations and may increase policy rates. Additionally, food inflation would be influenced critically by the performance of the monsoon. The stock of MSS bonds, which was used to infuse liquidity in 2008-09 and 2009-10, has dwindled following redemption and de-sequestering. As a result, the options are likely to be limited for the RBI as it seeks to manage Government borrowing without stoking inflation or raising the cost of borrowing for the Indian corporate sector in a scenario in which credit demand from the private sector is expected to recover and drive economic growth. While the availability of other sources of funding besides banks will remain important to fuel the pace of private investment growth in 2010-11, keeping a check on the volume of Government borrowings would be vital to ensure that private investment demand is not crowded out.

Conclusion

The fiscal measures adopted by Gol in 2008-09 to contain the slowdown in economic growth as well the expenditure measures instituted prior to the slowdown played a significant role in avoiding a deep and prolonged economic downturn. As expected, the fiscal balances of Gol deteriorated substantially in 2008-09 and 2009-10. With recent data suggesting a strong revival in economic growth, the timing is therefore appropriate for Gol to reverse some of the expansionary measures that it had instituted in the wake of the economic slowdown and resume a focus on fiscal prudence.

As a result, the Union Budget for 2010-11 is expected to focus on measures to augment revenues and restrict the growth of revenue expenditure in order to effect a substantial improvement in the level of the revenue and fiscal deficits. In particular, the Budget is expected to provide a calibrated roadmap for the phased reversal of the tax cuts that had been instituted in 2008-09 as part of the fiscal stimulus packages, to enhance revenues without threatening the revival in economic growth. Additionally, social sector outlays on identified schemes are likely to be enhanced, while curtailing the overall growth of revenue expenditure. With higher disinvestment proceeds likely to be targeted, the Budget is expected to enhance allocations for capital expenditure to boost infrastructure spending and provide momentum for economic growth. The overall theme is likely to be one of fiscal prudence to ensure a return to a fiscally sustainable level of deficits and borrowings and signal a firm commitment to the process of fiscal consolidation by adhering to the medium term fiscal path suggested by the Thirteenth Finance Commission.

An early return to fiscal prudence is also necessary to ensure that the revival in economic growth is sustained and that large Government borrowings do not crowd out private investments. However, the

manner in which fiscal consolidation is sought to be achieved without compromising on the growth prospects would be watched.

The other issues that would be of importance would include the trajectory of reforms in the areas of food, fuel and fertiliser subsidies, tax codes, implementation of GST and the disinvestment programme. Steps taken to reduce leakages and improve targeting of social sector schemes, measures to speed up implementation of infrastructure projects and steps to revive private investment demand are keenly awaited.



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