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India: Fiscal deficit likely at 6.8% of GDP, without disinvestment

- The UPA government presented an inclusive growth budget, increasing plan expenditure by 0.7% of GDP.
- The central government's fiscal deficit is budgeted at 6.8% in FY10 versus 6.0% in FY09, higher than expected.
- Gross market borrowing is likely at INR4.5trn in FY10 versus INR3.6trn in the interim budget, higher than expected. Just INR11.2bn is expected from disinvestment and INR350bn for 3G auctions.
- The FY10 fiscal deficit target looks to us to be achievable and could be lower if disinvestment proceeds trickle in.

Expectations of a reform-orientated budget were high this year, after the Congress-led UPA government won a decisive majority in the general election. In the event, the government signalled its medium-term policy intent towards economic reforms, increased social sector spending in line with its agenda of inclusive growth, but did not tap into alternate sources of financing the fiscal deficit.

Social sector expenditure: Total expenditure is budgeted to rise by 13.3% y-o-y in FY10 to INR10.2trn versus 26.4% in FY09 (Figure 1). Within this, plan expenditure is budgeted to increase by 14.9% y-o-y to INR3.3trn in FY10 (Nomura: INR3.2trn), an increase of INR422bn (0.7% of GDP) over FY09, broadly in line with our expectations. Much of this increase in plan expenditure is aimed at promoting inclusive growth, with the allocations greatest to agriculture (up INR17bn in FY10 over FY09), education (+INR50bn), health (+INR28bn) and rural development (+INR58bn). Within infrastructure, plan spending on power (+INR31bn), road transport (+INR20bn) and railways (+INR53bn) was hiked substantially, while urban development was trimmed by INR16bn less. Non-plan expenditure, which comprises interest payments, subsidies, defence and wages, is expected to rise by 12.6% y-o-y in FY10.

Limited fiscal stimulus: Given signs of an economic revival, the budget refrained from any large fiscal stimulus. Instead, it focused on the vulnerable segments of the economy by extending the interest rate subsidies for the employment-intensive export sectors, facilitating credit flow to micro, small and medium-sized enterprises at reasonable rates, and extending sunset clauses that allow deductions in respect of export profits.

Signalling intent on economic reform: The government used the budget as a vehicle to signal its commitment to economic reform on oil price deregulation, the introduction of a goods and services tax (GST) from April 2010, and fiscal consolidation. On the GST, the Finance Minister clarified that there will be a dual central and state tax. On fiscal consolidation, the government said it will return to the FRBM target as soon as possible and is waiting for the 13th Finance Commission to submit its recommendations by October 2009. On other reforms, the government announced plans to move towards a nutrient-based fertiliser subsidy regime over time, while on disinvestment, the government will retain at least 51% equity in public-sector enterprises and stated clearly that banks and insurance companies will remain in the public sector. However, with no clear-cut roadmap for disinvestment and price deregulation, the market has been disappointed with the budget.

Conservative on the revenue front: Direct tax rates were broadly left unchanged, except for an abolition of the fringe benefits tax and commodity transaction tax. To boost private consumption, the personal income tax exemption limit was hiked and a 10% surcharge on income tax was eliminated; the minimum alternate tax was raised from 10% to 15%. Overall, net tax revenue collections are budgeted to increase by 1.8% y-o-y in FY10 versus 6.0% in FY09, with the assumption of nominal GDP growth of 10% y-o-y in FY10. The budget has assumed fairly conservative tax revenue assumptions: corporate tax (15.6% y-o-y in FY10 versus 15.1% in FY09), income tax (-8.0% vs 19.4%), customs (-9.3% vs 3.7%), excise (-1.7% vs -12.2%) and services (0% vs 26.7%). The big disappointment, in our opinion, was the INR11.2bn expected from disinvestment (i.e. partial privatisation), which falls well short of the INR250bn that the economic survey had indicated. Non-tax revenues are likely to be boosted by INR350bn from the 3G spectrum auctions versus INR200bn in the interim budget.

The fiscal deficit and its financing: Overall, the government set a much higher fiscal deficit target of 6.8% of GDP, versus 6.0% in FY09 (Nomura: 6.8%), and also much higher than the interim budget target of 5.5%. With no significant disinvestment, gross market borrowing is budgeted at INR4.51trn in FY10, higher than the interim budget estimate of INR3.62trn and above expectations (Consensus: INR3.95trn; Nomura: INR3.97trn). In the medium-term, the government expects the fiscal deficit at 5.5% of GDP in FY11 and 4.0% in FY12.

Policy implications:

- On the whole, the fiscal deficit target of 6.8% of GDP does look realistic and it is in line with our forecast. In fact, as and when the government plans to divest its stake in public sector enterprises, and if higher growth accelerates revenue collections, the fiscal deficit could be lower. According to Reuters, S&P has said that India's rating faces no significant pressure and that India's fiscal deficit is within the expected boundary.

- Planned market borrowing is above expectations and has resulted in benchmark 10-year sovereign bond yields rising 30bp today to 7.0%. As mentioned, the actual gross borrowing could be lower if funds realised by disinvestment that are not budgeted materialise. Further, it is not clear whether the market stabilisation scheme (MSS) transfer of INR330bn is included in the borrowing of INR4.5trn; if so, actual bond supply is likely to be lower. The government has already borrowed INR1.6trn, or 36% of the full-year target, and INR180bn more than indicated in the borrowing calendar. This suggests to us that the government may have intentionally front-loaded a part of its borrowing programme to avoid crowding out private investment later in 2H FY10, by which time the private sector is likely to be wanting to borrow again..

- The direct impact of higher government spending on GDP, which is determined by revenue expenditure, is budgeted to increase by 11.7% y-o-y in FY10 versus 35.2% in FY09. Therefore, the contribution of government consumption in real GDP growth will be much lower in FY10. We reiterate our view that growth in government spending will fall sharply in 2H FY10 as economic recovery prompts a greater focus on fiscal consolidation, and also due to high base effects. We maintain our real GDP growth forecast at 6.3% y-o-y in FY10 versus 6.7% in FY09. Note that government capex is budgeted to rise by 26.8% y-o-y in FY10 after declining 17.5% in FY09, so whether the government is able to spend all of the money also remains to be seen.

- On monetary policy, the rate cutting cycle is over. As far as an exit strategy is concerned, we expect the Reserve Bank of India to withdraw liquidity by issuing Treasury bills under the MSS, possibly by as soon as 4Q09, particularly as capital inflows rise further. We expect this to then be followed by 100bp of cash reserve ratio hikes and a cumulative 75bp of policy rate hikes in 2010. Managing the government's borrowing programme will remain an ongoing challenge. According to the Finance Secretary, the government's heavy borrowing has to be supported by the RBI and open market operations are likely to be 50% of the total borrowing in FY10.

Figure 1. Central government's budget at a glance*

	FY08 Actual	FY09 RE	FY10 BE	FY09 RE	FY10 BE
		INRbn		% y-o-y	
1. Revenue Receipts (2+3)	**5419**	**5622**	**6145**	**3.7**	**9.3**
2. Tax Revenue (net)	**4395**	**4660**	**4742**	**6.0**	**1.8**
Corporation tax	1929	2220	2567	15.1	15.6
Income tax	1026	1226	1129	19.4	-8.0
Customs	1041	1080	980	3.7	-9.3
Union Excise Duties	1234	1084	1065	-12.2	-1.7
Service Tax	513	650	650	26.7	0.0
3. Non-tax Revenue	**1023**	**962**	**1403**	**-6.0**	**45.8**
4. Capital Receipts (5+6+7)	**1708**	**3388**	**4063**	**98.3**	**19.9**
5. Recoveries of Loans	51	97	42	90.2	-56.4
6. Other Receipts	388	26	11	-93.4	-56.4
7. Borrowings and other liabilities	1269	3265	4010	157.3	22.8
8. Total Receipts (1+4)	**7127**	**9010**	**10208**	**26.4**	**13.3**
9. Non-plan Expenditure	5076	6180	6957	21.8	12.6
10. Plan Expenditure	2051	2830	3251	38.0	14.9
11. Total Expenditure (9+10)	**7127**	**9010**	**10208**	**26.4**	**13.3**
12. Fiscal Deficit {11-(1+5+6)}	1269	3265	4010	157.3	22.8
% of GDP					
Fiscal deficit	**2.7**	**6.0**	**6.8**		
Revenue deficit	1.1	4.4	4.8		
Primary deficit	0.9	2.5	3.0		

**BE: Budget Estimate; RE: Revised Estimates.*

Source: Budget documents, CEIC and Nomura Global Economics.

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