CENTRUM

# Economic research

## Budget Preview: A Blockbuster budget or austerity

Economic Update

India I Economic Research

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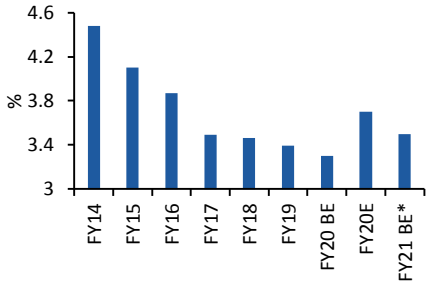
Institutional Research

**It is the budget time again. As usual, there are many expectations, and in anticipation, market is already rallying. Many of these hopes will be met. In our note, we do a deep dive into government's balance sheet and analyse how much of these expectations will be met. At the moment, govt. is running a tight fiscal deficit this year. YTD fiscal deficit has already surpassed the target by a significant margin (15%). Accordingly, the government has announced the curtailment in spending of up to INR 2.2 trillion. The pattern is however similar to the one observed last year. Even last quarter's retrenchment in expenditure might, fall short of preventing slippage because of lower than budgeted growth in tax revenue. Taking into account, lower than expected nominal GDP growth and likely postponement of divestment, we expect the deficit for FY2020 to witness 30-40 bps slippage from the budgeted target of 3.3%. This is our base case scenario. However, given the slow pace of growth in the economy, if government intervenes, this may elevate the fiscal deficit further. Markets have already priced in deviation from the target and are keeping a close eye on actions announced by the govt. authorities for the stressed sectors and for reinvigorating faltering consumption impulses.**

Fiscal deficit (% GDP)




Source: Controller General of Accounts, Centrum Research

### YTD fiscal deficit remains at elevated levels, questioning govt's ability to spend in Q4

Despite higher than expected growth in non-tax revenues and decent growth in non-debt capital receipts in FY20 so far, the higher FYTD accumulation of fiscal deficit is indicative of lower than expected tax revenue collection. According to the recent announcements, government departments have been asked to cut revenue expenditure in Q4 to 25% of annual budgets (from the 33% normally spent) as tax revenue growth was lagging the required rate by a wide margin.

### Lower transfers to states, dent the ability of states to spend

The prevalent economic slump has exerted severe downward pressure on the state finances the government's decision to cut corporate tax rates has not helped until now. So far, the transfers to states have shown deceleration by 2.34%. FYTD transfer to states stands at INR 4.32 tn (52% BE) against the budgeted target of INR 8.12 tn. The delays in transferring GST compensation due to states have only added to the pain. This has been affecting the states as 42% belongs to them. This will have an impact on the states' ability to spend. Collectively states spend 70% of the government expenditure.

### Payments related to AGR dues, likely to be a saviour

Supreme Court, in its decision, made on Oct 24, said that the definition of AGR would be widened to include the non-core operations as well. As a result, now, the telecom companies owe more than INR 90,000 cr to the DoT combined. This will provide a bonanza to the central govt. in a year like this where tax revenues are scarce.

### Divestment target unlikely to be met this year

The government has been able to achieve only about 17% of the disinvestment target so far this year. Acc. to the govt , receipts from disinvestment in the year to Mar are expected to be between INR 0.4-0.5 tn against the budgeted target of INR 1.05 tn as govt is unlikely to complete the sale of BPCL ,CONCOR, and Air India by Mar-end.

### In Conclusion

Given the challenging fiscal maths, we believe at the moment improving sentiments rather than increasing fiscal may do the trick. There are several things which government can do without affecting the fiscal significantly. Reintroduction of LTCG maybe with 2-yr period is most likely to uplift sentiments without having any significant impact on balance sheet of the govt. This holds potential to provide a major booster for stock markets as it is a provider of equity to the industry. Secondly, allowing tax breaks for buying property is likely to sort the real estate sector. The sector also expects quick implementation of alternative investment funds to rescue stressed residential projects. Another step, which can help without the much impact on fiscal, is abolishment of DDT. This will further boost the sentiments.

Strategy

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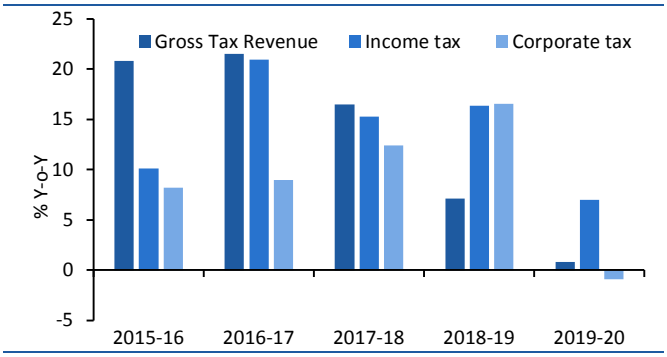
# Elevated YTD FD questions govt's ability to spend in Q4

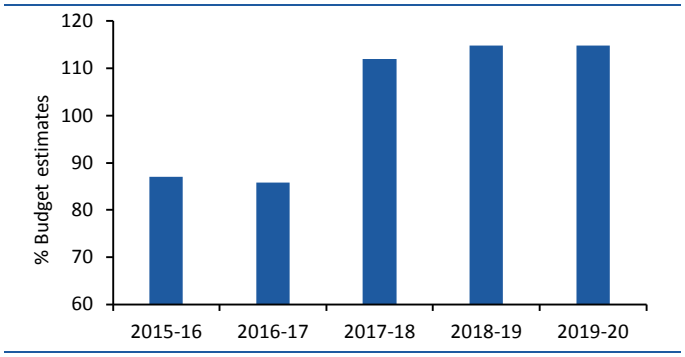
- Fiscal deficit, until the month of November 2019 accumulated to INR 8.1 tn, thereby registering a growth of 12.7% from November FY19. Fiscal deficit for Apr-Nov FY20 stood at 114.79% of full year's BE (budget estimate), similar to the FY19 print for the similar period. Revenue Deficit stood at INR 6.23 trillion with respect to INR 4.85 trillion-budgeted target for FY20.
- Compared to the actual print in the earlier years, fiscal deficit for April-November FY19 and FY20 happens to be the largest FYTD share of fiscal deficit accumulated by the central government as of November. Despite higher than expected growth in non-tax revenues (RBI's record transfer resulting into growth of 68%) and decent growth in non-debt capital receipts (14.48% growth in disinvestments) in FY20 so far, the higher FYTD accumulation of fiscal deficit is indicative of lower than expected tax revenue collection (mere 0.8% growth) and a relatively strong acceleration of capital expenditure (12% growth).
- Adhering the budgeted target of 3.3% seems to be a challenging task for the government amidst the on-going softness in economic activity that has largely resulted in the lacklustre growth of tax revenue collections so far. The faltering consumption impulses had been weighing on the growth since the onset of this fiscal year. However, the slowdown became pronounced in Q2FY20, thereby coercing the government authorities to intervene by announcing the corporate tax rate cut. This then raised the fiscal concerns radically as with corporate tax rate cut, government decided to forgo INR 1.45 trillion. The arithmetic showed the fiscal breach of 0.5% GDP in a situation if all the other estimates are met except the corporate tax revenue estimates.
- With the government pegging the first advance estimates of FY20 real GDP growth at mere 5%, nominal GDP growth is likely to remain at 7.5%. Recent announcements suggest that government departments have been asked to cut revenue expenditure in Q4 to 25% of annual budgets (from the 33% normally spent) as tax revenue growth was lagging the required rate by a wide margin. The Centre is all set to cut the annual budgetary expenditure for the current financial year by nearly INR 2.2 trillion or 8% from the budget estimate (BE). Spending across most ministries are most likely to bear the brunt, though budgeted capital investment is expected to remain intact.
- In the light of lower than expected nominal GDP growth, postponement of divestment proceeds and on the expectation of lower than budgeted transfer to the states coupled with the curtailment of revenue expenditure up to INR 2.2 trillion, we expect the actual print of fiscal deficit for FY2020 to witness 30-40 bps slippage from the budgeted target of 3.3%.
- Earlier, the slowdown in tax revenue collections were expected to be offset by the expectation of the attainment of budgeted disinvestment proceeds. However, the announcement of the deferment of major divestment proceeds has raised the fiscal concerns. Dispensations of RBI's record surplus along with the anticipation of lower than budgeted devolution to states are likely to limit the shortfall in receipts.

**Fig 1: Gross Tax revenue (Apr-Nov) remains lacklustre**




Source: Company, Centrum Research

**Fig 2: Fiscal Deficit (Apr-Nov) breached the target by 15%**



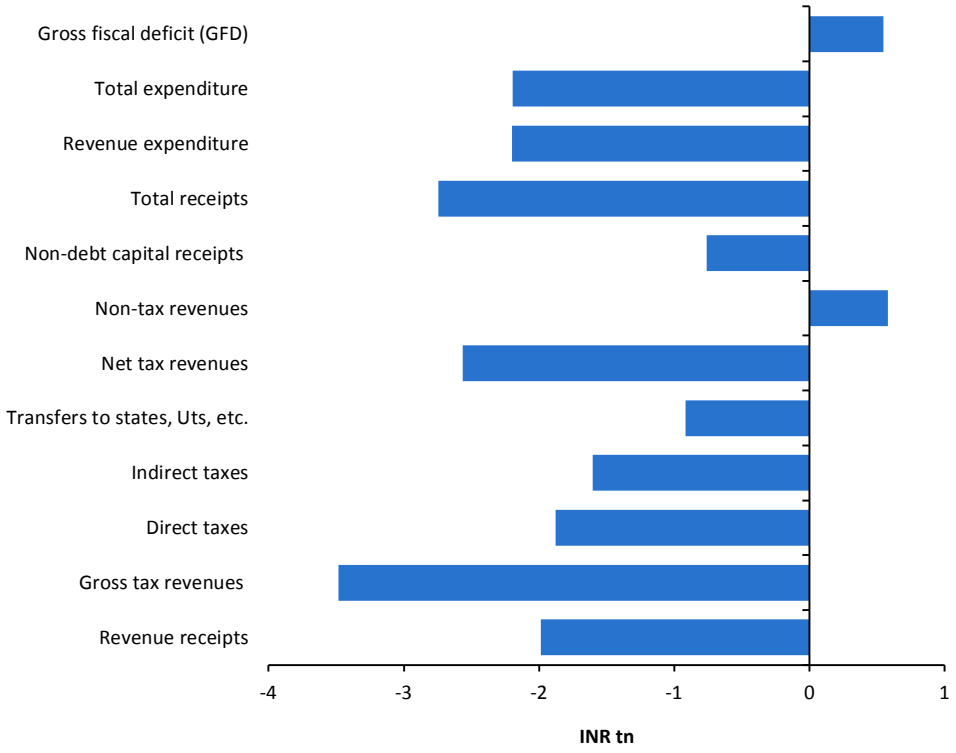

Source: Company, Centrum Research

**Fig 3: Fiscal Maths for FY20**

| INR tn | FY 2018 | FY 2019 | FY 2020 BE | FY 2020 E | Shortfall | Shortfall % | April-Nov FY 2019 | April-Nov FY 2020 | % BE |
|---|---|---|---|---|---|---|---|---|---|
| Revenue receipts | 14.35 | 15.63 | 19.63 | 17.64 | 1.99 | 10.13 | 8.70 | 9.83 | 50.09 |
| Gross tax revenues | 19.19 | 20.80 | 24.61 | 21.13 | 3.48 | 14.15 | 11.65 | 11.74 | 47.71 |
| Direct taxes | 10.07 | 11.43 | 13.42 | 11.54 | 1.88 | 14.01 | 5.42 | 5.57 | 41.47 |
| Indirect taxes | 9.12 | 9.37 | 11.19 | 9.59 | 1.60 | 14.31 | 6.17 | 6.17 | 55.11 |
| Transfers to states, Uts, etc. | 6.77 | 7.63 | 8.12 | 7.20 | 0.92 | 11.29 | 4.32 | 4.22 | 51.98 |
| Net tax revenues | 12.43 | 13.17 | 16.50 | 13.93 | 2.57 | 15.56 | 7.32 | 7.51 | 45.50 |
| Non-tax revenues | 1.93 | 2.46 | 3.13 | 3.71 | -0.58 | -18.45 | 1.39 | 2.33 | 74.27 |
| Non-debt capital receipts | 1.16 | 1.03 | 1.20 | 0.44 | 0.76 | 63.27 | 0.26 | 0.29 | 24.21 |
| Total receipts | 15.51 | 16.66 | 20.83 | 18.08 | 2.75 | 13.19 | 8.97 | 10.12 | 48.60 |
| Revenue expenditure | 18.79 | 20.09 | 24.48 | 22.28 | 2.20 | 8.98 | 14.22 | 16.06 | 65.62 |
| Capital expenditure | 2.63 | 3.03 | 3.39 | 3.39 | 0.00 | 0.00 | 1.91 | 2.14 | 63.15 |
| Total expenditure | 21.42 | 23.11 | 27.86 | 25.67 | 2.20 | 7.89 | 16.13 | 18.20 | 65.32 |
| Primary deficit (PD) | 0.62 | 0.63 | 0.43 | 0.98 | -0.55 | -127.91 | 3.68 | 4.66 | 1083.77 |
| Revenue deficit (RD) | 4.44 | 4.45 | 4.85 | 4.64 | 0.21 | 4.31 | 5.51 | 6.23 | 128.45 |
| Gross fiscal deficit (GFD) | 5.91 | 6.45 | 7.04 | 7.59 | -0.55 | -7.80 | 7.17 | 8.08 | 114.78 |
| Nominal GDP at market prices | 170.95 | 190.10 | 211.01 | 204.36 | 6.65 | 3.15 | | | |
| PD/GDP (%) | 0.40 | 0.30 | 0.20 | 0.48 | | | | | |
| RD/GDP (%) | 2.60 | 2.30 | 2.30 | 2.27 | | | | | |
| GFD/GDP (%) | 3.50 | 3.40 | 3.30 | 3.71 | | | | | |

Source: CGA, Centrum Research, Our estimates

**Fig 4: Expected deviation from the budget estimates**




Source: CGA, Our estimates

# Decoding the receipts side

As far as the government receipts are concerned, significant slowdown in economic activity has dented the towering expectations of attaining the budgeted target. Total receipts until November stood at INR 10.12 trillion, thereby accounting for only 49% of the budgeted estimates so far with sluggish growth in tax revenues. Since the budget estimates for FY20 were put forth in July, tax revenue collections seemed unrealistic given the widespread anticipation of lacklustre growth ahead. In addition, the target for divestment set across by the government looked unattainable too. However, the announcement of RBI's transfer of surplus funds to the government trimmed the probability of a sizeable slippage. Now, the deferment of divestment proceeds has coerced the government to curtail spending with intent to limit the slippage.

## Weak macro is hurting tax collections

**Direct Taxes**: Gross tax revenue collections accelerated by mere 0.8% during Apr-Nov FY20 relative to the robust pace of 7.12% in the corresponding period in FY19. The limited traction is largely attributable to direct taxes, which showed sluggish growth of 2.74% YoY during Apr-Nov FY20 from 16.48% in the corresponding period in FY19. Within direct taxes, both corporate and personal income tax collections have exhibited a substantial magnitude of slowdown in growth, registering de-growth of 0.9% in corporate tax and 7% growth in income tax respectively with respect to 16-17% growth during the similar period.

**Indirect Taxes**: Similarly, indirect taxes showed contraction by 0.87% with respect to 0.12% growth in FY19. growth in GST collections have also moderated with CGST, IGST, and Compensation Cess clocking 62.43%, 21.4%, and 57.24% of FY20 BE as of Nov, vis-à-vis the actual print of 49.23%, 44%, and 69.55% respectively during the corresponding period in FY19.

With government of India, pegging advance estimates for FY20 at 5%, prospects of meaningful traction in H2FY20 seems to have diminished substantially and the anaemic growth in overall economic activity is likely to weigh heavily on tax revenue collections for the rest of the year. Therefore, taking into account the announcement of corporate tax rate cut, ongoing sluggishness in tax revenue collections coupled with the estimation of nominal GDP growth at 7.5% for FY20, we estimate a deviation of INR 3.48 trillion in gross tax revenues i.e. 1.7% GDP from the documented.

## Lower tax transfers, denting the ability of states to spend

The prevalent economic slump has exerted severe downward pressure on the state finances the government's decision to cut corporate tax rates has not helped until now. Poor implementation of the goods and services tax along with a series of GST rate cuts and now the corporate tax cut has led to a dwindling of revenues. The delays in transferring GST compensation due to states have only added to the pain. This has been affecting the states as 42% belongs to them. Therefore, the central transfers are declining. In addition, GST is also not growing, for not only the centre but also the states. Despite estimating significant shortfall in gross tax revenue, net tax revenue (Gross Tax revenue-Transfer to states) has been restricted at INR 2.57 trillion after taking into account lower than estimated devolution of taxes to the states. So far, the transfer to states have shown deceleration by 2.34%. Given, the government has decided to make serious erosion in the transfers this fiscal and looking at the subdued trend so far, we anticipate a deviation of nearly INR 0.92 trillion from the budgeted estimate.

## Payments related to AGR dues, likely to be a saviour

The Supreme Court, in its decision, made on October 24, said that the definition of AGR would be widened to include the non-core operations as well. This increased the dues that the telecom companies pay over the AGR such as the license fees, the spectrum usage charge, and the penalties and the interests, which come over it. As a result, now, the telecom companies, Airtel and Vodafone Idea, both owe more than INR 0.9 trillion to the DoT combined. According to government officials, the telecom companies owe INR 92,642 crore in unpaid licence fee and INR 55,054 crore in spectrum usage charges. Non-tax revenue collection that stood higher at 74.27% of FY20 BE as of November vs. the actual print of 56.57% in the corresponding period in FY19 is highly attributable to greater than budgeted transfer of dividends and profits from the RBI. Taking into account, higher than budgeted transfer of RBI's dividend along with the anticipation of the payments related to AGR dues as telecom receipts, we estimate INR 0.92 trillion excess amount to provide a cushion in the revenue receipts. If the payments related to AGR dues are received by the government from various telecom and non-telecom entities within the 90 days stipulated by the Supreme Court, there could be a sizeable upside to the government's non-tax revenues.

## Divestment process set with the right earnest, likely to bear fruit in FY21

Non-debt capital receipts have stood lower at 24.21% of FY20 BE as of November vs. the actual print of 28.5% in the corresponding period in FY19. As of end Nov-19, the government was able to raise INR 180.99 bn through disinvestments vis-à-vis the budgeted target of INR 1050 bn. The government has been able to achieve only about 17% of the disinvestment target so far this year. According to the government officials, receipts from disinvestment in the year to March are expected to be between INR 0.4 trillion and INR 0.5 trillion against the herculean budgeted target of INR 1.05 trillion as government is unlikely to complete the strategic sale of Bharat Petroleum Corporation (BPCL), Container Corporation of India (Concor), and Air India by March-end. So far, in the current fiscal year, the government has heavily relied on the exchange-traded funds to divest its stake. It has raised INR 10,000 crore from the fifth follow-on offer of CPSE ETF during the fiscal year and INR 4,368 crore from the second follow-on offer of Bharat 22 ETF. However, we still believe that INR 0.5 trillion seems optimistic, given the ongoing pace and with no big divestment in pipeline for FY20.

## Total Receipts are likely to miss BE target by INR 2.7 trillion

Total gross taxes collected by the Centre (before transfer to states) will likely miss BE targets by INR 3.5 trillion Substantial shortfalls are expected in income tax, excise collections (despite the INR 2 per litre hike in petrol and diesel taxes), and corporation tax (given the tax rate cut and weak corporate profits). Shortfall of GST balances used by the Centre might be 0.32% of GDP. On non-tax revenues, the expected shortfall from disinvestments is most likely to be outweighed by higher dividend incomes from RBI coupled with the payments related to AGR dues. Portion of the shortfall will be restrained by the 42% (of central taxes collected net of cesses and surcharges) lower required transfer to states, INR 1 trillion, meaning the effective shortfall on the Centre's budget will be limited to INR 2.57 trillion.

**Fig 5: Break-up of the Receipts side**

| INR tn | FY 2018 | FY 2019 | FY 2020 BE | FY 2020 E | Shortfall | Shortfall % | April-Nov FY 2019 | April-Nov FY 2020 | % BE |
|---|---|---|---|---|---|---|---|---|---|
| Revenue receipts | 14.35 | 15.63 | 19.63 | 17.64 | 1.99 | 10.13 | 8.70 | 9.83 | 50.09 |
| Gross tax revenues | 19.19 | 20.80 | 24.61 | 21.13 | 3.48 | 14.15 | 11.65 | 11.74 | 47.71 |
| Direct taxes | 10.07 | 11.43 | 13.42 | 11.54 | 1.88 | 14.01 | 5.42 | 5.57 | 41.47 |
| Corporation tax | 5.71 | 6.64 | 7.66 | 6.28 | 1.38 | 18.02 | 2.50 | 2.89 | 37.68 |
| Income tax | 4.31 | 4.74 | 5.69 | 5.19 | 0.50 | 8.79 | 2.91 | 2.68 | 48.17 |
| Indirect taxes | 9.12 | 9.37 | 11.19 | 9.59 | 1.60 | 14.31 | 6.17 | 6.17 | 55.11 |
| Goods and Services Tax | 4.43 | 5.82 | 6.63 | 5.82 | 0.81 | 12.26 | 3.92 | 4.08 | 61.51 |
| CGST | 2.03 | 4.58 | 5.26 | 4.60 | 0.66 | 12.55 | 2.97 | 3.28 | 62.43 |
| IGST | 1.77 | 0.29 | 0.28 | 0.28 | 0.00 | 0.00 | 0.22 | 0.06 | 21.40 |
| Compensation cess | 0.63 | 0.95 | 1.09 | 0.94 | 0.15 | 14.00 | 0.63 | 0.63 | 57.24 |
| Customs duty | 1.29 | 1.18 | 1.56 | 1.43 | 0.13 | 8.27 | 0.87 | 0.76 | 48.70 |
| Excise duty | 2.59 | 2.31 | 3.00 | 2.34 | 0.66 | 22.00 | 1.38 | 1.33 | 44.30 |
| Transfers to states, Uts, etc. | 6.77 | 7.63 | 8.12 | 7.20 | 0.92 | 11.29 | 4.32 | 4.22 | 51.98 |
| Net tax revenues | 12.43 | 13.17 | 16.50 | 13.93 | 2.57 | 15.56 | 7.32 | 7.51 | 45.50 |
| Non-tax revenues | 1.93 | 2.46 | 3.13 | 3.71 | -0.58 | -18.45 | 1.39 | 2.33 | 74.27 |
| Non-debt capital receipts | 1.16 | 1.03 | 1.20 | 0.44 | 0.76 | 63.27 | 0.26 | 0.29 | 24.21 |
| Recovery of loans | 0.156 | 0.178 | 0.148 | 0.14 | 0.01 | 5.41 | 0.10 | 0.11 | 73.72 |
| Disinvestments | 1 | 0.85 | 1.05 | 0.3 | 0.75 | 71.43 | 0.16 | 0.18 | 17.24 |
| Total receipts | 15.51 | 16.66 | 20.83 | 18.08 | 2.75 | 13.19 | 8.97 | 10.12 | 48.60 |

Source: CGA, Centrum Research, Our estimates

# Decoding the expenditure side

On the expenditure side, total expenditure stood at INR 18.2 trillion (12.82% growth) with revenue expenditure and capital expenditure increasing by 13% and 12% on YoY basis until Nov'19. Recent announcements suggest that government departments have been asked to cut revenue expenditure in Q4 to 25% of annual budgets (from the 33% normally spent) as tax revenue growth was lagging the required rate by a wide margin. The Centre is all set to cut the annual budgetary expenditure for the current financial year by nearly INR 2.2 trillion or 8% from the budget estimate (BE). Spending across most ministries are most likely to bear the brunt, though budgeted capital investment is expected to remain intact. With actual expenditure this year likely to be around INR 25.86 trillion, or 92% of the BE, the spending reduction from BE level this year could be the sharpest since FY15.

## Revenue exp. mainly led by healthy spending in agriculture

In regard total expenditure, 65.32% of the budgeted estimates has been incurred so far relative to 66.06% of FY19 BE as of Nov. Revenue expenditure pace has been maintained at 12.97% YoY during Apr-Nov FY20 vis-à-vis 9.82% seen in the corresponding period in FY19. The growth in revenue expenditure stemmed mainly from higher transfers to states, elevated pace of spending in agriculture, fertilizer subsidy, petroleum subsidy (cooking gas and kerosene), heavy industries and public enterprises, human resource development and law. However, revenue spending has declined in food subsidy, Jal Shakti Yojna and in rural development.

## Urban housing and railways lead the capital spending

Capex has grown by 11.7%, largely from 16.0% growth in defence outlay, 21% growth in railways, significant growth in telecommunications and 30.1% in urban housing. Spending toward road transport has only grown 1.3% YoY. Capex is currently being led by Ministry of agriculture, department of atomic energy, chemical and fertilizers, communications, development in north-eastern region, external affairs, HRD, labour and employment, MSMEs, renewable energy and textiles.

## Rural focus continues

It is important to note that rural spending by the central government (including Ministry of Agriculture and Farmer's Welfare, Department of Fertilizers, Drinking Water and Sanitation, Ministry of Panchayati Raj & Ministry of Rural Development) grew 20.8% YoY in the first seven months of FY20, marking the highest growth in the past 11 years. Consequently, the share of rural spending in the centre's total spending rose sharply from 11.3% in FY19 to the 8-year high of 13.3% in FY20. Recent released monthly fiscal figures demonstrates a mixed picture as spending for rural development has shown contraction of nearly 0.4% and even food subsidy growth has shown marked contraction relative to the previous year. However, the pace of spending in ministry of agriculture has remained healthy with fertilizer subsidy showing growth of 37% YoY with mere 8% growth in FY19 for the period April-November.

## Total Expenditure likely to miss BE target by INR 2 trillion

Taking into account, the recent announcement of the government to curb revenue expenditure to restrict larger slippage, we expect government to curtail expenditure by INR 2.2 trillion by the partial rollover of subsidies and by reducing expenditure in various ministries by 25%. This is most likely to result in sharper cuts in the rest of the year for the ministries who have underspent in early part of the year. Slower disbursements under the PM Kisan scheme, deferment in subsidy payments and delay in rolling out of sectoral measures announced in 2H19, are most likely to restrict expenditure.

The spending curbs being imposed now to avoid a big fiscal slippage would, however, weaken the one pillar of the economy government expenditure that has been holding the fort for other constituents of the economy like private investments/consumption and

exports that have lost steam. Notably, the slashing of the Centre's budget spending comes at a time when the state governments have also reined in their expenses in the wake of revenue shortfall. Recent announcement of curtailment in revenue expenditure by the government is likely to ease fiscal constraints but also raises probability of protracting the current phase of economic slowdown.

**Fig 6: Break-up on the expenditure side**

| INR tn | FY 2018 | FY 2019 | FY 2020 BE | FY 2020 E | Shortfall | Shortfall % | April-Nov FY 2019 | April-Nov FY 2020 | % BE |
|---|---|---|---|---|---|---|---|---|---|
| Revenue expenditure | 18.79 | 20.09 | 24.48 | 22.28 | 2.20 | 8.98 | 14.22 | 16.06 | 65.62 |
| Interest payments | 5.29 | 5.83 | 6.61 | 6.61 | 0.00 | 0.00 | 3.48 | 3.42 | 51.73 |
| Subsidies | 1.91 | 1.97 | 3.02 | 2.82 | 0.20 | 6.53 | 2.19 | 2.35 | 77.89 |
| Food | 1.00 | 1.02 | 1.84 | 1.64 | 0.20 | 10.97 | 1.42 | 1.32 | 71.76 |
| Fertilizer | 0.66 | 0.71 | 0.80 | 0.80 | 0.00 | 0.00 | 0.53 | 0.73 | 91.60 |
| Petroleum | 0.25 | 0.25 | 0.38 | 0.38 | 0.00 | 0.00 | 0.23 | 0.30 | 78.82 |
| Capital expenditure | 2.63 | 3.03 | 3.39 | 3.39 | 0.00 | 0.00 | 1.91 | 2.14 | 63.15 |
| Total expenditure | 21.42 | 23.11 | 27.86 | 25.67 | 2.20 | 7.89 | 16.13 | 18.20 | 65.32 |

Source: CGA, Centrum Research, Our estimates

## Slower than budgeted revenues likely to result into additional borrowings this quarter

- The Centre had announced in September that it would borrow INR 2.68 trillion from the bond market in the second half of FY20, maintaining the full-year gross borrowing target at INR 7.1 trillion. Net borrowings were budgeted at INR 4.7 trillion in this FY, of which INR 2.7trillion was in the second half i.e. October 2019 to March 2020.
- Ongoing sluggish growth in revenues have raised the possibility of additional borrowings this quarter, even as funds under the small saving schemes have been kept at a high of INR 1.3 trillion. The rate of interest on the deposit schemes continue to remain at elevated levels and has not been lowered despite 135 bps rate cuts by RBI.
- Anticipation of higher borrowings and stickiness of the rates on these savings have kept the term premium at elevated levels. This has been one of the many factors, which has been partially responsible for deterring the transmission process of the substantial monetary stimulus that has already been delivered.
- Incomplete transmission amidst such a critical slowdown coerced the central bank to adopt unconventional policy tool in order to expedite lending by making the cost of capital or funds cheaper for business and industry and other borrowers.
- RBI's move of 'Operation Twist' came at a time when term premium remains at multi-year highs (90-100 bps between 10-year and 2-year). The decision clearly elucidates the RBI's uneasiness with persistently high yields at the long end of the curve, which have been partially responsible for hampering monetary transmission.
- Three tranches have been conducted since December 2019 and markets are expecting more such buy-sell OMOs to narrow this spread. More events of operations twists are most likely to offer some respite to the markets that already remain cautious of looming fiscal concerns and inflation pressures.
- In addition to the looming concerns of fiscal deficit from centre front, there has been rising concern over the overall high public borrowings persists (centre, state and public sector enterprises). States finances have also remained anaemic due to weaker collections, burden of lagged pay increases, power-related debt and rising dependency on tax revenues from the government (GST compensation, divisible pool etc.).

## Fiscal Deficit can deviate from the baseline scenario

- Taking note of the past trend, government might end up deferring payments to the next FY, in line with accounting framework. Government in that case might end up adhering the path of consolidation or can deviate by mere 10 bps from the budgeted target. In such a situation coupled with the severe retrenchment in budgeted expenditure or undertaking additional dividends from RBI or PSUs or higher spectrum or AGR dues from telecom companies, fiscal deficit can remain intact or stand at 3.4%.
- Government can also limit the announced cut in expenditure. If the expenditure is curtailed by INR 1.4-1.5 trillion. In that scenario, deficit can go up to 3.85% of GDP. The escape clause in the Fiscal Responsibility and Budget Management (FRBM) Act allows a fiscal slippage of up to 50 basis points or 0.5 per cent of GDP in exceptional conditions. The government may invoke this clause in 2019-20. In this scenario, most of the slippage from the revenue side will be absorbed and there will hence be lower need for aggressive spending next year.

## Higher off budgeted borrowings

- Historically, government has been resorting to heavy expenditure reductions to keep the deviation of fiscal numbers intact, In FY19, government trimmed spending by INR 1.31 trillion, as tax revenue target missed target by 11%. However, the spending was in large part covered through off budget spending in FY19.
- Government managed to attain the target of 3.4% fiscal deficit by underreporting expenditure. In FY 2019, total food subsidy to FCI stood at INR 2.6 trillion (INR 1.25 trillion for the year and INR 1.36 trillion of arrears from past years). With allocation of just INR 1.02 trillion this year, FCI' share will be lower than the total food subsidy, implying that the liability will more than INR 1.6 trillion. Therefore, in order to finance the past and future operations, FCI has borrowing the exorbitant amount. FCI borrowed INR 1.86 trillion from NSSF (National Small Saving Fund).
- The borrowing that should be ideally shown as expenditure in government's books is shown as debt as the government does not pay the FCI on time and thereby, manages to push the expenditure onto the debt. The major issue with such funding is that the government would have to maintain a higher interest rate on small savings to attract household deposits in such small savings funds. This would mean elevated costs of capital for the economy and would hinder the monetary transmission process, rendering cuts in policy rates ineffective. The other concern with such borrowing is the problem of crowding out private borrowing.
- In July 2019, the Comptroller and Auditor General (CAG) reported that the central government's key deficit figures might be considerably higher than stated in the union budget. In a presentation to the 15th Finance Commission (FFC) on July 8, three days after the July 5 budget, CAG had asked whether the extra-budgetary resources accounted for in the budget reflect the correct picture.
- To make its point, the auditor re-calculated the fiscal deficit of 2017-18 to show that it actually works out to 5.85%. The government had reported a fiscal deficit of 3.46% that year. Since then, India's deficit numbers have come under sharp scrutiny as the government has been increasingly depending on off-budget borrowings to fund capital expenditure and even revenue expenditure such as food and fertiliser subsidy arrears. However, the reporting is such that the actual extent of the borrowing is unclear even to budget experts.

# Budget FY 21: Fiscal Math likely to remain realistic

- Markets are most likely to remain watchful of the fiscal math, economic programs, policies and strategies of the incumbent government, enunciated in the Budget. With restricted fiscal space amidst the ongoing significant economic slowdown, it would be imperative to scrutinize prudently, government's fiscal roadmap for the FY21 and their steps towards curbing the faltering economic growth.
- Given the economic recovery in FY21 is expected to remain very gradual and is unlikely to exhibit a V shaped recovery, we expect some moderation in revenue assumptions, particularly GST and direct taxes. Revenues through asset sales and non-tax revenues are expected to rise, complemented by the already announced pipeline of strategic sale options. Nominal GDP at 8.5%-9.5% will be realistic. Fiscal deficit target is likely to be set at 3.5% of GDP.
- We do not expect consolidation, as at the time of slowdown, it is likely to derail path of recovery. In the light of further deferment of disinvestment target, government should aim at accomplishing this target in FY21 in order to limit fiscal deficit and thereby, alleviating the risk of crowding out private investment by limiting market borrowings and restricting the risk of a sovereign rating downgrade by agencies.
- Keeping the fiscal deficit target a tad higher (within acceptable limits) under such circumstances, tends to act as an automatic stabilizer, which is expected to fuel growth faster than expected, as was done in the aftermath of the global financial crisis in 2008. We reiterate again that we do not advocate breach of fiscal deficit by an exorbitant margin as already announced measures in various sectors, accompanied by the corporate tax cut, easing monetary conditions, and improved agricultural income is also likely to steadily provide an impetus to growth.

## Budget FY21: Market Expectations

### Personal Income Tax cut

The key expectation from the Budget is that of increasing the threshold limit for the minimum amount not chargeable to tax, from INR 250,000 to INR 500,000. The last such increase was made almost 5 years back when this was increased from INR 200,000 to INR 250,000 in the FY15. Hence, such an increase is long overdue and is one of the most popular demands floated by salaried individuals in India. Similarly, there is also the expectation that the highest tax slab rate may come down from 30% to 25%, with a corresponding increase in the limit from INR 10 lakh to INR 20 lakh. However, we believe that the effectiveness of tax cuts to stimulate demand and investments remains doubtful in a scenario of weak confidence. Moreover, direct tax cuts will have a limited impact given the following facts: With a population of around 1.3 billion, India has only 80 million individual taxpayers. Of this, around 22 million pay zero tax.

### Withdrawal of DDT

While taxpayers' anticipation on withdrawal of Dividend Distribution Tax has been on for several years now, the probabilities are stronger due to the objective of the government to rationalise corporate tax rate and promote economic growth. All taxpayers will likely welcome abolishment of DDT and this will be considered as one of the steps towards ease of doing business in India. It may also contribute to paving the way for achieving the government's aspiration to make India a USD 5 trillion economy.

### Government may remove LTCG tax on 2 year equity holding

Following the much criticism received on the re-introduction of the tax and looking for means to attract more long-term foreign investment, the government might remove the LTCG (long-term capital gains) tax on equities in the upcoming Budget 2020. The definition of "long-term" on equities may be changed from one year to two years.

### Rural focus

In line with the past budgets, social sector measures are likely to gain traction, as previously signalled by a sustained push towards electrification of villages, sharpening MGNREGA focus, improve quality and quantity of healthcare availability, education, skill-training, creating vocational institutes etc.

### Sector Specific Measures

- While there is no guarantee on whether the government will announce any deduction in personal income tax, markets expect the budget is likely to focus on sector-specific measures to address challenges as sector-specific boosters are necessary to revive overall demand growth. The government needs to take specific steps to help stressed sectors such as real estate, telecom, discoms and non-banking financial companies.
- To boost manufacturing as part of the 'Make In India' campaign, the government is expected to address the issue of inverted duty structure, especially in sectors such as chemicals and electronics.
- The real estate sector, which is struggling with a huge pile of unsold inventory in recent years, expects dole from the finance minister. The sector contributes more than 8 percent to the Indian economy. The sector expects quick implementation of alternative investment funds to rescue stressed residential projects. Allowing tax breaks for buying property is likely to sort the real estate sector.
- The commerce and industry ministry has proposed to the finance ministry to address the inverted duty structure on several products such as consoles, panels, certain steel products, calcined alumina, ethyl acetate, and viscose staple fibre. Inverted duty structure affects the domestic industry adversely as manufacturers have to pay a higher price for raw material in terms of duty, while the finished product lands at lower duty and costs.
- Government might announce a sponsored Fund of Funds (FoF) of INR 10,000 crore to support VC/PE firms investing in the MSME sector that will support crowd funding from venture capital and private equity firms, which focus on investing in the MSME segment on modified term sheets developed by SIDBI. This would encourage innovation in term-sheets and product structures.

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