

India budget: A 'game-changer' or not?

DBS Group Research

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Summary

The new government's much-anticipated budget exercise is scheduled for July 6. Apart from the usual interest over size and allocation of government spending in the budget, this budget is also keenly watched for the tone it sets in terms of the reform agenda of the new government. We expect the government to target a deficit of 6.5% of GDP for FY09 (ends Mar10), 1%-pt wider than the 5.5% target set in the interim budget in February, and retain forecasts of 7% and 11% growth in real and nominal GDP in FY09. We expect the budget to be populist and inclusive, but also set a credible if slightly ambitious roadmap to trim the deficit over the next five years. In terms of the sectoral emphasis, we expect infrastructure sector to receive the greatest attention, followed by agriculture and education.

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Since the election outcome a month ago, there are many signs that the government is serious about liberalizing policies and delivering inclusive development, and importantly, that it understands the limitations of any new policies if it doesn't pay attention to the constraints on delivery and governance. We are optimistic that the budget and the months ahead would see constructive plans, policies and initiatives from the government. However, we believe that many of the policy changes may yield benefits (in terms of higher growth) only in the longer run. At the same time, we are cognizant of the risks that remain on the policy implementation front, and also the more immediate risks to stability from the fiscal position. For example, we are yet to feel confident about the speed with which or the degree to which the government would liberalize oil prices. Indeed, we think it is likely the government exceeds its deficit target given its overly optimistic growth and revenue assumptions. As such, the fiscal position makes the economy vulnerable in the face of external shocks. The possible loss of investor confidence in the market should not be underestimated if risk scenarios such as poor monsoon and elevated crude oil prices actually play out. On the whole, despite brightening longer-run prospects, short-term stability risks remain.

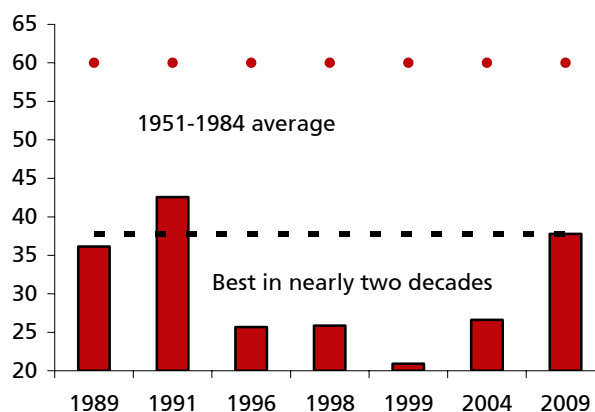
Necessary ingredients for reforms in place - the push factors and the pull factors

Optimistic in the long-run: necessary ingredients for reforms in place

We may not be able to predict the twists and turns ahead in policy direction and implementation, but, knowing that the right combination of developments and motivations prevail greatly enhances the chances of actual implementation of further reforms. Indeed, the most important reason we expect the government to present a reformist budget and signal a reformist agenda is that many necessary ingredients for reforms, in the present Indian context, appear to be in place: these

India: Best electoral performance in two decades for Congress party

% of seats won by Congress party



are political will & opportunity (pull factor), the mere need for reforms to sustain growth (push factor) and cracking the 're-election code' (the means). We expand on these aspects below.

(1) 'Pull' factor - Political will & opportunity: After two decades of witnessing its decline and the rise of regional parties, the Congress party has come back with a stronger mandate in the latest general elections (*see chart, previous page*). It has tasted 'partial' success and is now hungry for 'complete' success - i.e.: regaining its historic position and coming back to power as a single party government. This is something it cannot do if the status quo continues. We believe this points to a strengthened political will to overcome hurdles to reform.

(2) 'Push' factor - the economy 'needs' reforms at this juncture to return to and sustain 8-9% growth rates. The lack of fiscal room means that the government cannot boost growth or deliver inclusive development simply by accelerating spending. The country's infrastructure is creaking and a binding constraint on growth. Education has to be revamped and delivered well if the so-called demographic dividends (i.e.: higher growth from rising working age population) have to be enjoyed. Agriculture has to be reformed to ensure both food security as well as national security (Maoist insurgencies grow where the state has failed). Many of the above changes cannot be delivered if governance is poor and the administrative machinery is weak and riddled with corruption and inefficiencies. Ironically, this dire straits is the best 'push' factor for reforms, including the usually politically difficult governance reform. The Congress party also appears to understand that it cannot come back to power with a stronger majority just by just doing more of the same (after all, the electorate is still not happy, the party fell well short of an outright majority).

(3) 'The means' - cracking the re-election code: To begin, the stronger mandate gives the party the space to pursue its agenda, something it did not have sufficient room for in the past five years. At the same time, it has the 'means' now. Having broken the anti-incumbency factor prevalent in the last two decades, the Congress party thinks it has cracked the 'code' to winning re-election by delivering inclusive development. The key to winning elections is not as obvious as it seems, as many parties win votes on issues other than development (such as caste, religion e.t.c.). Indeed, good economics has not meant good politics for nearly two decades. In 1996 and in 2004, the Congress party and the right-wing Bhartiya Janata party lost elections despite pursuing wide-ranging economic reforms and overseeing periods of high growth. In other words, the party now has hit upon a combination of 'smaller' government and 'better' government that it believes will deliver inclusive development and hence win votes.

...yet, better to be realistic in the short-run, even cautious

A game changer, can only change the game so fast in India. The change would unlikely be dramatic - the political and administrative structure do not allow for dramatic change. It is often said that the Indian political system has the wheels of an ox-cart and the brakes of a Rolls Royce. This is why we do not see an easy return to 8-9% growth (unless global growth is extremely strong). Infrastructure, education, governance cannot be reformed in an instant or even in the space of a year. The first generation of reforms that began in late 80's / early 90's involved largely 'letting go' or de-regulation and liberalization. Hard as letting go is, the actual administration of such reforms can be fast. While there is still plenty of 'letting go' for the government to do, the most urgent reform agenda ahead - not only for distribution of the pie but for growing the pie - involves improvement in government administration and governance. However, such reforms are often the hardest to implement. To be sure, the government's initiative to set up a national citizen database would go a long way to improve governance and trim leakages and corruption. Assigning Nandan Nilekani, co-founder of software firm Infosys and its former CEO to head the Unique Identity Authority of India has strengthened hopes for successful implementation. Even so, a project of this nature may take years to implement, and may well be

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incomplete in the current government's term. These implementation risks aside, widening twin deficits make us wary of stability risks in the short-run (more on this later).

Specific budget expectations :

(1) Deficit target to be raised, major tax rates to be left unchanged

Additional expenditure to be spent on food security, infrastructure and education

We think the mind-set of the current government is to push as much expenditure to kick-start inclusive development as it can. It would probably see a deficit of 6.5% of GDP as a 'ceiling' of sorts, at least for the budget target (sticking to the target is another issue). This is 1%-pt wider than the interim budget target of 5.5% of GDP. Additional excise duty cuts introduced after the interim budget and lower revenue collection due to weaker growth should widen the deficit by almost 1%-pt of GDP while additional one-off revenues from divestment of stakes in government enterprises and 3G license sales may contribute 0.5%-pt of GDP worth funds to the budget. Therefore, working backwards, this should leave the government room for additional expenditure of at most 0.5%-pt of GDP (+1%-1%+0.5%). Assuming, the government to retain forecasts of 7% and 11% growth in real and nominal GDP in FY09, our calculations points to room for about 8% rise in plan expenditure from levels penciled in February (*see table*). As a result, budgeted borrowing should rise to INR 3.8trn from INR 3.1 trn estimated in the interim budget.

To the extent that the election verdict is interpreted as a vote for inclusive development, the government would aim to allocate greater funds for flagship schemes that deliver the same. As the President's inaugural address to the parliament already mentioned a new Food Security Act, and implementing the same would be very expensive, the government might attempt to partly deliver this through expansion of 'food for work' programmes. The government may attempt to expand the scope of the National Rural Employment Guarantee Scheme (NREGS) so that the aim of overall rural development is met, and at the same time, job security for the rural poor is improved. The education sector is also likely to receive a significant portion of the rise in plan expenditure given the necessity to improve skill levels to reap the demographic dividends. We do not expect the government to introduce any significant changes to tax rates aside from micro-level tinkering around and further incentives to boost export sectors hit by the downturn. Indeed, the government may indicate its intention to raise excise duty and reduce stimulus once the economy recovers. Nonetheless, given

India: Budget estimates and DBS forecasts (FY09/10)

	BE (Feb) Govt est.	BE (July) DBSf	Likely actuals DBSf	Govt target % chg	Likely actuals % chg
	INR bn	INR bn	INR bn	from Feb	from Feb
Expenditure	9532	9631	9284	1.0	-2.6
Plan exp	2851	3077	2966	7.9	4.0
Non-plan exp	6681	6554	6318	-1.9	-5.4
Gross tax revenue	6713	5995	5494	-10.7	-18.2
Net tax revenue	4976	4258	3757	-14.4	-24.5
Non-tax revenue receipts	1120	1099	1059	-1.9	-5.4
Total revenue receipts	6096	5357	4816	-12.1	-21.0
Misc capital receipts	11	326	326		
Fiscal deficit	3328	3851	4044	15.7	21.5
Nominal GDP	60214	59071	56942	-1.9	-5.4
Nom GDP % YoY	(11% YoY)	(11% YoY)	(7% YoY)		
Fiscal deficit (% of GDP)	5.5	6.5	7.1		
Market loans	3086	3609	3802	17	23
Market loans (% of GDP)	5.1	6.1	6.7		

Note: BE refers to Budget estimates; Source: budget documents, DBS forecasts

our expectations for real GDP growth to disappoint the government's target of 7%, we see the revenue targets as ambitious and expect the fiscal deficit to hit 7% of GDP eventually. This should lead to budgeted borrowing rising past the new INR 3.8trn target (*see table*).

(2) Roadmap to rein in the deficit & implement tax & expenditure reforms

We also expect the budget to lay out a roadmap to rein in the deficit in the medium-term. The government would likely target narrowing the deficit to 3% of GDP by FY2013 and may introduce methodology to measure the same on a cyclically adjusted basis (in the past five years, the rapid reduction in the deficit was partly due to temporary improvement in tax revenue collections due to strong growth, leading to overconfidence on the fiscal front). Achieving the target entails reducing the deficit by 0.7%-pt of GDP each year - ambitious without material tax and expenditure reforms. There may even be plans to subsume subsidy related payments to oil companies in the budget. Even if it is too late to move towards a nation-wide goods and services tax (GST) by April 2010, the government can come up with a workable strategy to effect the transition by 2011. It would be important for the government to signal its intention in sticking to any new deadlines, both for the GST roadmap as well as the roadmap to return to fiscal sustainability. The government would also likely assert that the move to national biometric identity cards is a major expenditure reform, as it would greatly reduce leakages and help target subsidies better. This major reform gains credibility merely on the appointment of a capable head, but the task remains Himalayan.

(3) Reforms - focus on infrastructure, education and agriculture

We expect to see the government impress upon investors and the nation its intent on reforms, improved policy implementation and improved service delivery. Although the budget is meant to be an accounting exercise and not necessarily a policy setting exercise, we do expect the government to outline its strategy for the next five years. This will also help the government 'sell its case' and attract investments necessary to meet its budget targets, besides helping it to avert any ratings downgrade (though we think it may not be successful on the latter).

Apart from tax and expenditure reforms outlined earlier, we think the emphasis would foremost be on the infrastructure sector. Education sector, land reforms, and governance reforms would also be emphasized. We expect measures to accelerate infrastructure spending, improve access to long-term financing and improve institutional and individual capacity of the public sector in handling public-private-partnership projects. Specifically, these may include regulatory measures to make it more attractive for banks to buy longer term bonds, measures to increase depth of corporate debt market, measures to raise equity financing, possibly roping retail investor funds directly, and ideas or proposals to rope in academic institutions to strengthen managerial, technical and administrative capabilities of relevant public sector employees. The government might also indicate intention to provide clarity on land acquisition policies at the earliest. These have been the biggest hurdle for both infrastructure development and special economic zones expansion. The government may reveal any intent or plans to incorporate technology such as GIS mapping to better monitor infrastructure projects and identify points of delay.

It may also try to impress its seriousness in implementing at least some of the reforms suggested by the administrative reforms commission and other expert committees to improve governance. For example, steps to effectively implement decentralisation to urban local bodies and rural local bodies may be outlined, possibly including improving capacity of staff through training, and usage of technology to improve supervision and accountability. To improve food security and better target subsidies, pilot projects may be expanded to implement a

Reforms to focus on infrastructure, especially addressing financing and administrative constraints

system of food stamps or direct cash transfer to replace the wasteful and inefficient public distribution system (smart biometric cards are still many years away).

In terms of de-regulation, we may not get as much as we like from the budget, though we should further into the year. Divestment of stakes in public sector companies though is all but certain (at most 0.5% of GDP) since this is needed to bridge the deficit. It would be very encouraging if FDI limits are raised in insurance, education, aviation if only up to 49%, but this may not necessarily happen on the budget day itself. Even more positive would be plans to liberalize oil pricing, if only partially. But, we are not confident that the government would speedily liberalize prices, though it likely eventually will.

Policies to improve governance and equity should not be viewed as less pro-market or pro-growth than de-regulation and liberalization. Indeed, pursuit of market reforms alone has hardly produced stable governments at the centre in the past two decades. On the other hand, pursuit of inclusive development along with liberalization should strengthen the government's political capital, and ability to initiate tough reforms. The only difference is the impact is likely to be in the longer-run rather than immediate. Infrastructure policy reforms and tax reforms may be the only areas where impact on the economy is visible this year or next itself. Improvements in governance would likely take longer to make a difference.

Risks to the fiscal position and the economic outlook

Implementation risks and fiscal risks are the two main risks to the outlook ahead.

(1) Implementation risks:

Much of the positives in the budget for the economy are likely to be related to the statement of intent and initiation of various steps to address some of the regulatory, administrative and governance issues plaguing sectors such as infrastructure, education, agriculture, food distribution e.t.c. Therefore, implementation risks are inherent as the budget would be an enunciation of 'promises'.

(2) Fiscal risks :

Apart from slow implementation, the outlook also remains fraught with other risks. The main reason is the unfavourable, even precarious starting point. For one, the government ran a national deficit (including off-budget) of over 11% of GDP in FY08. While remittances over 4% of GDP helped limit the current account deficit to under 3% of GDP in FY08, the merchandise trade balance also recorded double digit deficit as a share of GDP. This makes the economy vulnerable to external shocks, especially oil price shocks. This especially as the ability (or the willingness) to pass on higher global prices to retail consumers remains limited (given poor governance and still widespread discontent). As such, expenditure remains highly inflexible on the downside, particularly in the short-run.

Perhaps, one can say the worst combination of events played out in FY08 from a fiscal and balance of payments perspective. This has hopefully jolted the administration out of any complacency on the prospects for Indian economy and the headroom to run deficits and imbalances. However, given the wider deficit targeted in the budget, it may be difficult to avoid an eventual downgrade in debt ratings. Should oil prices continue to rise, or should the monsoon fail to pick up, ratings agencies would have no choice but to downgrade ratings. Indeed, our view of Indian economy would also materially worsen if the government fails to at least initiate partial de-regulation in oil prices (such as free market prices up to a cap) in the face of rising global prices. While there is talk of de-regulating retail oil prices, it is not clear if it will come fast enough to avert further damage to the fiscal position.

Implementation risks are inherent as the budget would be an enunciation of 'promises'

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