Economic Analysis

# Time for a Big Push – our expectations from India's upcoming Union Budget

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On February 28th India's Modi government will present its first full year Union Budget for the year ending March 2016 (FY16). The ruling BJP led alliance headed by Mr. Modi won a landslide victory in national elections last May on a promise to revive India's sluggish economic growth through sweeping reforms. However, its first nine months in office have been bereft of the highly anticipated legislative reforms, although the new government has made headways in implementing executive reforms and improving India's investment climate. These include 1) steps to improve bureaucratic governance standards, 2) strengthening trade and investment ties, 3) completely deregulating diesel prices, 4) raising foreign investment limits in defense, railways and insurance, 5) easing food supply bottlenecks and 6) expediting environmental clearances for infrastructure projects. We believe these steps would be helpful for India's economic recovery, but they are no substitute to deeper legislative reforms across key areas such as taxation, labor, land acquisition, energy and infrastructure.

Against this backdrop, the forthcoming Union Budget and the subsequent budget session of Parliament provides the best opportunity for India to kick-start major structural reforms, while articulating a credible fiscal consolidation plan. That being said we believe that the budget is no magic wand and a credible follow-up is critical. Below is the list of top priorities, which we think the Indian Government should focus in its forthcoming Budget.

**Stick to a credible fiscal consolidation plan:** India's gross government deficit (central and state combined) at about 6.7% of GDP in FY14 is the highest amongst emerging economies across Asia (around 3.0% of GDP). A weak fiscal balance has not only undermined India's capex growth by crowding out private investments but also constituted a key risk to India's sovereign credit profile. In this context, we expect the budget to lower target fiscal deficit from 4.1% of GDP in FY15 to 3.6% of GDP in FY16 and further below 3.0% of GDP by FY17. A credible action plan with long-term solutions to achieve the fiscal targets would be watched for in the budget. The good news is that the sharp decline in international oil prices substantially lowers India's aggregate fuel subsidy burden from 0.6% of GDP in FY15 to an estimated 0.2% of GDP in FY16. With subsequent budgetary savings being channelized towards productive spending, the government's capital expenditure budget will likely be higher compared to last year. All in all, we believe that fiscal deficit reduction should remain the Government's top priority.

**Enhance simplicity, clarity and stability in the tax regime:** India's aggregate tax to GDP ratio is extremely low at 11%, which is not even comparable to its regional peers such as China (19%), Thailand (17%), Malaysia (15.5%) and Philippines (14.2%), not to mention advanced economies such as the UK (39%) and US (27%). Relatively low tax revenues impede the government from investing in the country's much-needed infrastructure. It is thus imperative for India to expand its direct taxes net, restructure the complex indirect tax structure, scrap retrospective tax amendments and provide tax incentives to attract foreign investments.

> Increasing India's direct tax base: With only 3% of India's roughly 1.2 billion citizens paying income tax, the new budget will be watched for measures such as 1) Including high agriculture income earners under the tax net, 2) expediting the tax dispute resolution process and 3) providing greater autonomy to India's nodal tax agencies. Also, unlike several instances in the past, the new budget should avoid raising income tax exemption limits. As household incomes rise, leaving tax exemption limits unchanged would help widen India's tax base. Meanwhile, steps to simplify India's corporate

tax structure, which is characterized by surcharges and sector-specific exemptions that encourage rent seeking and tax evasion, would be positive.

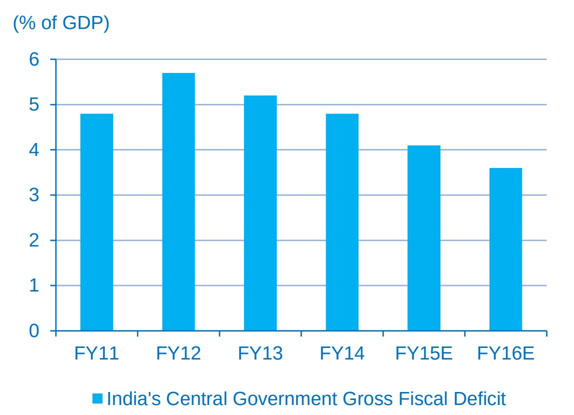
Restructure Indirect taxes – Goods and Services tax (GST): Barring certain issues related to finalizing on the optimum tax rate and center-state revenue sharing, the Modi government is on track with its plan to implement the Goods and Services Tax – a uniform tax rate that aims to replace all indirect taxes, in turn simplifying tax procedures, enhancing transparency and broaden tax collection. With the deadline for GST roll-out set as April 1st 2016, the budget session of parliament will be crucial for passing the enabling legislation required for GST implementation.

**Step up non-tax revenue receipts:** A steady pick-up in activity momentum combined with the government's recent decision to levy excise tax on fuel should improve tax revenues in FY16. Tax revenues to GDP fell to multi-year lows last year to an estimated 9.5% of GDP. Yet, a sharp recovery in tax collections seems unlikely this year given structural constraints. The government should therefore step up non-tax revenue receipts from divestments in public and private companies and auction of telecom licenses.

**Explore avenues for productive spending:** Given the need for fiscal prudence, we expect the new budget to explore avenues for productive spending while reducing the subsidy bill and better target essential subsidies. Of particular focus would be higher infrastructure spending aimed at upgrading roads, railways, ports and rural infrastructure. Other likely expenditure outlays include incentives for low-cost housing, to boost manufacturing activity, to improve financial health of India's debt ridden state electricity boards, and fresh capital infusion in public sector banks to meet Basel-3 requirements.

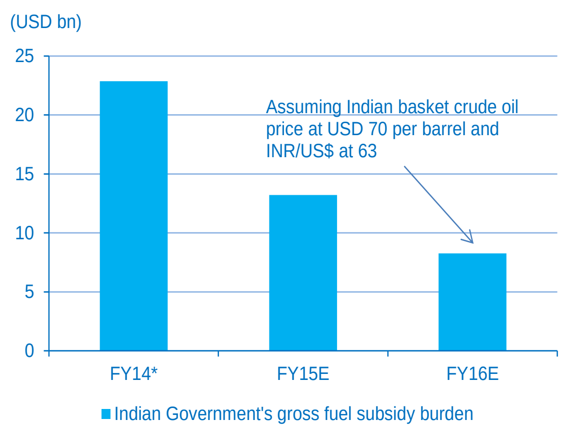
**Build a consensus in parliament for passing key legislative reforms:** Legislation remains a significant obstacle for the new Government given its lack of majority in the upper house of Indian parliament. This has weighed on India's ability to push through difficult structural reforms across land acquisition, labor, mining and taxation. The government's ability to build a political consensus and enact reforms will be tested in the ensuing budget session of Indian parliament. Key bills/ordinances pending approval in the parliament include 1) Coal Mines bill to facilitate transparency in coal block allocation and boost private sector commercial mining, 2) Insurance law to boost foreign investments in insurance sector, 3) Land Acquisition Bill, 4) Goods and Services Tax Bill and 5) Labor Reforms (Amendments to Factories Bill).

Figure 1
**India's upcoming budget expected to stay focused on reducing India's high fiscal deficit**




*FY11: Fiscal Year ending March 2011; Source: BBVA Research, CEIC

Figure 2
**Oil led reduction in subsidy burden has enhanced space for budget to boost capital spending**




*FY14: Fiscal Year ending March 2014; Source: BBVA Research, CEIC