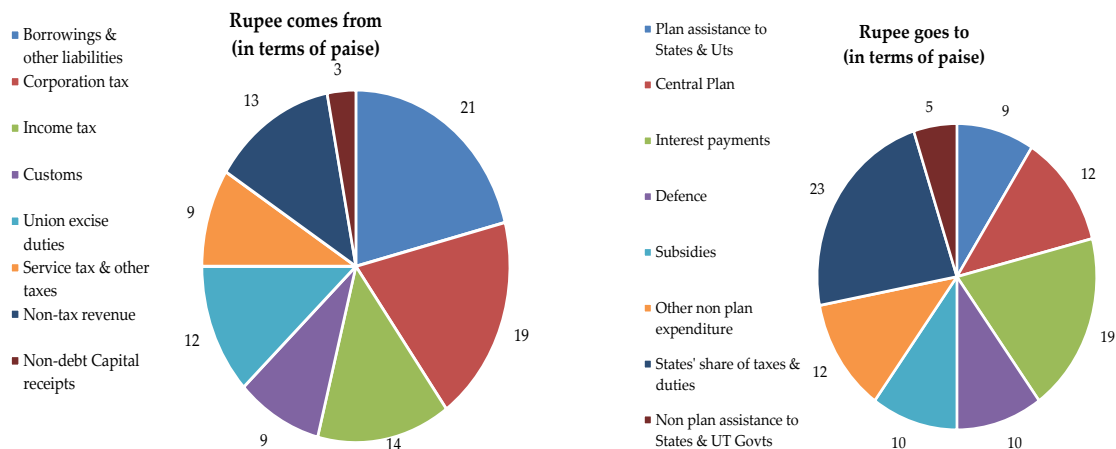


Budget 2016: Ticks the right boxes

Highlights:

- The government committed to a fiscal deficit to GDP target of 3.5% for 2016-17. We think that the government has provided for a realistic set of tax revenue targets. However, the main risks to the fiscal deficit to GDP target are likely to come from possible downside risks from the disinvestments proceeds and spectrum auctions.
- There is also a risk stemming from the full implementation of the seventh pay commission recommendations. It appears that for now only 'an interim amount' has been assumed in the fiscal calculations for the revision in government salaries.
- There was greater emphasis on reviving the agricultural and rural sector:
 - **Agriculture and Farmer's Welfare** – The government increased allocation and plans to double farmer income by 2022.
 - **Rural Sector** – allocation for rural sector at Rs 87,765 crore (of which Rs 38,500 crore allocated for MGNREGS). There were also other measures taken to revive the rural infrastructure sector.
- **Public Sector Banks (PSB)** – (a) Recapitalization of PSBs – Rs 25,000 crore provided in FY17 (b) roadmap to be spelt out for consolidation of PSBs (c) considering reduction of Government equity in IDBI Bank to 49% (d) Debt Recovery Tribunals (DRTs) to be strengthened with computerized processing of court cases.
- **Make in India** – Changes in customs and excise duty rates on certain inputs to reduce costs and improve competitiveness of domestic industry in sectors like Information technology, Hardware, capital goods, defence production etc.
- **Rationalization of tax structure** – 13 cesses, levied by various Ministries in which revenue collection is less than ` 50 crore in a year to be abolished.
- **Changes in FDI Policy** – 100% FDI through FIPB route will be permitted for marketing of food products, produced and manufactured in India.
- **Removal of –plan /non Plan classification from 2017-18**
- **No changes have been made to existing income tax slabs**



Source: India Budget & HDFC Bank

The intra-day volatility in the domestic equity markets during Mr Jaitley's budget speech perhaps best captured the difficulty the market had in assessing the impact of the budget without poring over the details. Our sense is that the budget does try to address some of the key concerns of the economy without straying away from the medium term fiscal consolidation path.

Table 1: The fiscal arithmetic

	(INR CR)				% GDP			% YoY		
	FY15 RE	FY16 BE	FY16 RE	FY17 BE	FY16 BE	FY16 RE	FY17 BE	FY16 BE	FY16 RE	FY17 BE
1.Revenue receipts	1101472	1141575	1206084	1377022	8.1	8.9	9.1	3.6	9.5	14.2
<i>Tax revenue(net to centre)</i>	903615	919842	947508	1054101	6.5	7.0	7.0	1.8	4.9	11.2
<i>Non- tax revenue:</i>	197857	221733	258576	322921	1.6	1.9	2.1	12.1	30.7	24.9
<i>--Spectrum auctions</i>	30624	42866	56034	98995	0.3	0.4	0.7	40.0	83.0	76.7
2.Capital receipts ex borrowings	51475	80253	44217	67134	0.6	0.3	0.4	55.9	-14.1	51.8
<i>Recovery of Loans</i>	13738	10753	18905	10634	0.1	0.1	0.1	-21.7	37.6	-43.8
<i>Other receipts:</i>	37737	69500	25312	56500	0.5	0.2	0.4	84.2	-32.9	123.2
<i>--Disinvestment & strategic disinvestments</i>	37737	69500	25313	56500	0.5	0.2	0.4	84.2	-32.9	123.2
3.Total receipts ex borrowings (1+2)	1152947	1221828	1250301	1444156	8.7	9.2	9.6	6.0	8.4	15.5
4.Non-plan expenditure	1201029	1312200	1308194	1428050	9.3	9.6	9.5	9.3	8.9	9.2
<i>4.1.Revenue</i>	1109394	1206027	1212669	1327408	8.5	8.9	8.8	8.7	9.3	9.5
<i>4.1.1.Interest payments</i>	402444	456145	442620	492670	3.2	3.3	3.3	13.3	10.0	11.3
<i>4.1.2.Subsidies</i>	258258	243811	257801	250433	1.7	1.9	1.7	-5.6	-0.2	-2.9
<i>4.2.Capital</i>	91635	106173	95525	100642	0.8	0.7	0.7	15.9	4.2	5.4
5. Plan expenditure	462644	465277	477197	550010	3.3	3.5	3.7	0.6	3.1	15.3
<i>5.1.Revenue</i>	357597	330020	335004	403628	2.3	2.5	2.7	-7.7	-6.3	20.5
<i>5.2.Capital</i>	105047	135257	142193	146382	1.0	1.0	1.0	28.8	35.4	2.9
6.Total expenditure (4+5)	1663673	1777477	1785391	1978060	12.6	13.2	13.1	6.8	7.3	10.8
<i>6.1.Revenue</i>	1466992	1536047	1547673	1731037	10.9	11.4	11.5	4.7	5.5	11.8
<i>6.2.Capital</i>	196681	241430	237718	247023	1.7	1.8	1.6	22.8	20.9	3.9
Fiscal deficit (3-6)	510726	555649	535090	533904	3.9	3.9	3.5	-	-	-
Revenue Deficit (1-6.1)	365520	394472	341589	354015	2.8	2.5	2.3	-	-	-
Primary deficit (3-6-4.1.1)	108282	99504	92470	41234	0.7	0.7	0.3	-	-	-
Nominal GDP	12488000	14108945	13567192	15065010	-	-	-	13.0	8.6	11.0

Source: India Budget & HDFC Bank

Infrastructure: continues to get an emphasis

On the expenditure side, the focus continued to be on providing a thrust to the infrastructure sector, particularly roads. For one, budgetary allocations for road construction is at a hefty Rs 82000 crores and large allocations to infrastructure capex keeps the plan capital expenditure (a broad proxy for overall government capex) at 1 per cent of GDP, the same as 2015-16. This is no mean feat given that in 2015-16 planned capital spending had grown by a whopping 35 percent over the previous year. The railways, the other possible engine of growth, have received a fairly hefty government support of Rs 45000 crores this year. It is now up to the ministries to get projects shovel ready to absorb these allocations.

Rural economy: steps taken to revive rural demand

The other important development was a greater focus than in the previous budget to reviving the rural economy. While there is a general tendency to view any overtures to the rural sector as intrinsically populist, the dire conditions in the agrarian economy seem to warrant immediate attention. The FM extended support via both short-term income bearing schemes like the MNREGA and investments in rural infrastructure particularly in irrigation and road connectivity that would pay off more in the medium term. Construction activity under these investment programmes is known to have quick multiplier effects and this could subsequently drive an upswing in rural demand in 2016 itself.

Banking recapitalization: Not a total disappointment

Although the allocation of only INR 25,000 crore to recapitalize banks was deemed as inadequate given the sheer size of stressed asset problem, this infusion of government funds is perhaps the most that the FM could afford at this stage and as he has promised to supplement it later. The allocation certainly recognizes the fact that the tottering PSBs desperately need government assistance and alternative funding sources are scarce. If stock and bond markets improve over the year this initial handholding by the government could help to 'crowd in' private investment in their capital.

Fiscal assumptions: How realistic?

The 11 per cent nominal GDP growth does not seem too aggressive considering a 7.5 per cent growth in real GDP and a GDP deflator that is likely to go up from this year's 1 per cent on the back of a base effect alone. While the large number of additional cesses could have some contractionary impact on the sectors that they have been imposed on, the absence of a service tax hike perhaps offsets this. The fact that the much feared redefinition of the 'long term' to measure capital gains for stocks was absent should also bring some cheer to the markets. The finance minister lowered the corporate tax rate that he had committed to in the last budget cautiously if not half-heartedly. However, the fact that really small enterprises get the initial benefit is welcome since they have borne the brunt of the economic slowdown.

Which part of the fiscal arithmetic can raise a few eyebrows then? The gross tax collection growth of 11 per cent seems achievable given the new cesses and the continuing impact of the increase in oil cess introduced in the middle of last year. However, it is certainly possible to question the numbers projected for capital receipts. For one, divestments are budgeted at Rs 35000 crores that given current market conditions seems unrealistic. But then market conditions are known to change. The strategic sales target of around Rs 21000 crores would succeed only if the government puts some of its profitable companies on the block – there's unlikely to be much of an appetite for chronically loss making units. A substantial amount of around Rs 99000 crores has been budgeted from telecom receipts but that doesn't seem terribly out of whack with the valuations of over Rs 4 lakh crores that analysts have made for saleable 4G (700MhZ) spectrum auction. However whether telecom companies have the resources to shell out this kind of money next fiscal year remains a key question. One hopes that some of the potential shortfall under these heads can be made up from the money received through the tax amnesty scheme that has been announced.

Table 2: Tax revenue targets seem feasible

Growth rate in key tax categories			
(In YoY %)	FY16 BE	FY16 RE	FY17 BE
Indirect tax collection	18.9	29.2	10.8
Union excise duties	21.7	50.5	12.2
Custom duties	10.8	11.4	9.8
Service tax	24.9	25.0	10.0
Direct tax collection	14.7	8.1	12.6
Corporation tax	9.7	5.6	9.0
Wealth tax	-	-	-
Income tax	23.2	12.5	18.1
Taxes on Union Territories	11.7	23.2	4.4
Gross tax revenue	16.4	17.2	11.7
Less surcharge for financing NCCF	64.4	70.8	9.1
Less assignment to states	55.1	49.8	12.7
Net tax revenues	1.8	4.9	11.2

Source: India Budget & HDFC Bank

Table 3: Subsidy burden likely to fall further in FY17

Category (in Rs crores)	FY15 RE	FY16 BE	FY16 RE	FY17 BE
Major subsidies	249016	227388	241857	231782
--Fertilizer subsidy	71076	72969	72438	70000
- Food	117671	124419	139419	134835
--Petroleum subsidy	60269	30000	30000	26947
Interest subsidies	7632	14903	13808	15523
Other subsidies	1610	1520	2136	3128
Total	258258	243811	257801	250433
Total Subsidies (% GDP)	2.1	1.7	1.9	1.7

Source: India Budget & HDFC Bank

Risks and areas of disappointment:

There's another risk that one needs to factor in. An 'interim' amount has been assumed for the revision in government salaries in line with the pay commission recommendations and a panel has been set up to arrive at the final structure. There is always the risk of the final structure crimping the fiscal space available since the non-plan expenditure budgeted does not seem to account for full implementation.

Moreover, what the budget seems to lack is a little fiscal or financial innovation to augment government resources both for the short and medium term. For instance, much has been discussed earlier about the plans to leverage the equity base of the National Infrastructure Investment Fund (NIIF) and the pressing need for the government to contribute to the asset reconstruction process of the financial system through a 'bad bank'. Perhaps these ideas need to be fleshed out a bit more before actually being implemented. However the finance minister could have started a conversation by an

explicit reference in his speech. The absence of a reference to the NIIF was conspicuous and disappointing.

Implications for rates:

The one positive aspect of the budget that cannot be overlooked was the adherence to the fiscal deficit to GDP target that should in turn enable the central bank to respond by cutting its policy rate. The finance minister has to fund his deficit by borrowing from the market and both his net borrowing and gross borrowing (grossed up from the money he needs to borrow for redemptions of past bond issues) are lower than median market expectations. This should arrest the rise in bond yields. Amidst an initial reaction to the budget outcome, Indian sovereign bonds rallied, driving the 10-year yield down by around 16bps. Government's adherence to the fiscal deficit target of 3.5% ushered market expectations for an inter-meeting policy rate cut. Meanwhile, the projected net borrowing for FY17 at Rs. 4.3 trn was somewhat less than market expectations, and altogether boosted sentiment in the bond market.

After a positive and preliminary reaction to budget, focus is likely to shift back to elevated supply of state development loans (SDL) and the magnitude of monetary easing going into FY17. Even as we expect bond yields to drift lower from the current levels, we do not see substantial movement on the downside. Looking at the demand-supply dynamics (we will release a more detailed report on this later on in the week), we take this opportunity to briefly outline the factors that could contain the bond rally in FY17:

- While net supply of Indian government bonds (IGBs) is likely to come down by 3.5% in FY17, that of SDLs is projected to rise by more than 20%.
- On account of OROP and Pay commission recommendations, and the fading base effect, there could be upside risk to the 5% inflation target (around 40bps in our view). This could restrain the policy rate cut beyond 25bps in FY17
- Subdued domestic demand could weigh on deposit growth and thus on the demand for SLR securities.
- Moreover, fresh supply of UDAY bonds is likely to weigh on the sentiment going forward.
- Depreciation of rupee could hurt un-hedged FII exposure

Table 4: Market borrowings were lower than expected

Market borrowing details					
Amt in Rs crores	FY14	FY15	FY16 BE	FY16 RE	FY 17BE
Fiscal deficit	502858	510726	555649	535090	533904
as % of GDP	4.4	4.1	3.9	3.9	3.5
Gross borrowings	564147	592000	600000	585000	600000
Redemptions	110597	138925	143595	144392	174819
Net borrowings	453550	453075	456405	440608	425181
% of fiscal deficit	90.2	88.7	82.1	82.3	79.6

Source: India Budget, RBI & HDFC Bank

Appendix

Union Budget 2016-17 – Major thrust areas

Agriculture and Farmer' Welfare

- Total allocation at Rs 35984 crores
- Farmer's income to be doubled by 2022
- Rs. 27,000 crore including State's share to be spent on PMGSY in 2016-17
- Rs. 9 lakh crore will be given as Agricultural credit in 2016-17.
- 28.5 lakh hectares of land will be brought under irrigation
- Dedicated irrigation fund in NABARD with an initial corpus of Rs.20,000 cr
- A provision of 15,000 crore towards interest subvention
- Allocation under Prime Minister Fasal Bima Yojana at Rs 5,500 crore.
- 5 lakh farm ponds and dug wells in rain fed areas and 10 lakh compost pits for production of organic manure will be taken up under MGNREGA
- Soil Health Card scheme will cover all 14 crore farm holdings by March 2017.

Rural Sector

- Allocation for rural sector at Rs 87,765 crore
- Rs 2.87 lakh crore will be given as Grant in Aid to Gram Panchayats and Municipalities
- A sum of Rs 38,500 crore allocated for MGNREGS.
- Every Block in drought and rural distress areas will be taken up under Deen Dayal Antyodaya Mission.
- 300 Rurban Clusters will incubate growth Centres in Rural Area.
- All villages will be electrified by 1st May, 2018.
- A new Digital Literacy Mission scheme will be launched for rural India to cover around 6 crore households in next three years.
- Modernisation of Land Records through revamped National Land Records Programme.
- Targeted Delivery of Government subsidies and benefits - DBT in fertilizer will be launched on pilot basis.
- MUDRA – Loan target of 1,80,000 crore in 2016-17.

Social Sector including health care

- Rs 2,000 crore allocated for initial cost of providing LPG connections to BPL families.
- New health protection scheme will provide health cover up to Rs One lakh per family.
- *National Dialysis Services Programme* to be started under National Health Mission through PPP mode
- *"Stand Up India Scheme"* to facilitate at least two projects per bank branch - to benefit at least 2.5 lakh entrepreneurs.
- National Scheduled Caste and Scheduled Tribe Hub to be set up in partnership with industry associations

Education, Skills and Job Creation

- Digital literacy scheme to be launched to cover 6 crore additional rural households
- 62 new Navaodaya Vidyalayas to be opened in remaining uncovered districts in next two years.
- Higher Education Financing Agency will be set up with an initial capital base of Rs. 1,000 crore.
- 1500 Multi Skill Training Institutes will be set up under Pradhan Mantri Kaushal Vikas Yojana
- Government of India will pay EPS contribution of 8.33% for all new employees enrolling in EPFO for the first three years of employment.
- Interlinking of State Employment Exchanges with National Career Service Platform.
- Small and medium shops to be permitted to remain open all 7 days a week on voluntary basis. New jobs in retail sector.

Infrastructure and Investment

- Total outlay for infrastructure - Rs 2,21,246 crore.
- To approve nearly 10,000 kms of National Highways in 2016-17.
- Guidelines for renegotiation of PPP Concession Agreements will be issued
- New credit rating system for infrastructure projects to be introduced
- Reforms in FDI policy in the areas of Insurance and Pension, Asset Reconstruction Companies, Stock Exchanges.
- 100% FDI to be allowed through FIPB route in marketing of food products produced and manufactured in India.
- A new policy for management of Government investment in Public Sector Enterprises, including disinvestment and strategic sale has been approved

Financial sector reforms

- A comprehensive Code on Resolution of Financial Firms to be
- A comprehensive Code on Resolution of Financial Firms to be introduced.
- Amendments in the SARFAESI Act 2002 to enable the sponsor of an ARC to hold up to 100% stake in the ARC and permit non institutional investors to invest in Securitization Receipts.
- Allocation of ` 25,000 crore towards recapitalization of Public Sector Banks.
- General Insurance Companies owned by the Government to be listed in the stock exchanges.

Fiscal Discipline

- Fiscal deficit in RE 2015-16 and BE 2016-17 retained at 3.9% and 3.5%.
- Revenue Deficit target from 2.8% to 2.5% in RE 2015-16
- Mobilization of additional finances to the extent of Rs 31,300 crore by NHAI, PFC, REC, IREDA, NABARD and Inland Water Authority by raising Bonds.
- Plan / Non-Plan classification to be done away with from 2017-18
- Every new scheme sanctioned will have a sunset date and outcome review.
- Committee to review the implementation of the FRBM Act.

Tax

- No changes have been made to existing income tax slabs
- 1 per cent service charge on purchase of luxury cars over Rs. 10 lakh and in-cash purchase of goods and services over Rs. 2 lakh.
- SUVs, Luxury cars to be more expensive - 4% high capacity tax for SUVs.
- Companies with revenue less than Rs 5 crore to be taxed at 29% corporate tax plus surcharge
- Excise 1 per cent imposed on articles of jewellery, excluding silver.
- 0.5 per cent Krishi Kalyan Cess to be levied on all services.

Personal Finance

- Govt. will pay EPF contribution of 8.33% for all new employees for first three years
- Deduction for rent paid will be raised from Rs 20,000 to Rs 60,000 to benefit those living in rented houses.
- Additional exemption of Rs. 50,000 for housing loans (for first time home buyers) up to Rs. 35 lakh, provided cost of house is not above Rs. 50 lakh.
- Service tax exempted for housing construction of houses less than 60 sq. m
- Withdrawal up to 40% of the corpus at the time of retirement to be tax exempt in the case of National Pension Scheme (NPS).

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