

Union Budget 2015 - Provides Long-Term Strategic Direction



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Every finance minister faces an almost insurmountable challenge in presenting a Budget that can please everyone. This is almost impossible by definition as the needs of the various constituents of the economy conflict with each other. Expectations were running high ahead of this budget, particularly after the July 2014 budget that was largely seen as a repeat of the earlier interim budget and lacked strategic direction. This budget ticks all the boxes by providing the strategic direction and is a welcome continuum of the stated policies and directional changes that have already been telegraphed by the government in its first nine months. But like any budget, it has its shares of hits & misses. Before we delve into that, it is crucial that we understand the biggest change which predates this budget and that is the change in the fiscal architecture of India with the government adopting the recommendations of the 14th finance commission which will result in 62% of revenues now flowing to the states. Central government expenditure relative to GDP at 12.6% of GDP is at near 25 - year low. This places more money in the hands of the states and increases their financial flexibility. The differences across Indian states in terms of demographics, income & education levels and social indicators is very high and this flow of additional revenue will enable states to tailor expenditure to meet their distinctive needs. This is a significant long term change which down-sizes the central government and gives more power to the states.

As for Budget 2015 in the misses department - the big one is the fiscal deficit. While the budget suggests that the government has achieved its 4.1% target for FY'15, it has deferred its medium term fiscal deficit target of 3% by one year from FY'17 to FY'18. For FY'16, the fiscal deficit target is now pegged at 3.9% vs. the earlier estimate of 3.6%. This is disappointing as not only has the target been pushed back but the effective revenue deficit has actually gone up. Driving this down to zero remains a giant sized challenge. Interest payments account for over 26% of the gross receipts of the central government and driving this revenue deficit lower has to be a key medium term target. As for the budgeted increase in revenue in the budget, it appears realistic but the economy needs more recovery traction for these numbers to be achieved. There is still significant reliance on disinvestment and one time revenues - this is lumpy and by nature unpredictable. The budget takes more money out of the hands of businesses and consumers - courtesy the hike in surcharge on income and corporate tax along with the higher service tax. Of course, this is a corollary to the need to bring in higher fiscal discipline. But the bottom line is that this amounts to higher taxes and a higher fiscal deficit. The increase in capital spending by the government is healthy compared to the actual in 2015 but is muted compared to the budget estimate of 2015. There is a ₹ 25,000 crore increase in spending on roads and railways but the rest of the money referred to in the budget is by CPSE's and not by the government. The quality of fiscal consolidation is not very high. The other miss in the Budget is a road map for re-capitalizing the PSU banks - the allocation is too low and given that these banks account for over 2/3rd of lending; we need more than just changes in the management structure. A banking system hobbled by NPAs and low capital adequacy cannot fund an investment cycle. The establishment of Special Purpose Vehicles that can be leveraged for infrastructure spending are merely financial structuring devices that move borrowings, which would otherwise be called part of the fiscal deficit, to a separate entity.

In the hits section, we now have a clear sense of direction of the fiscal policy over the next five years. The government has desisted from handing out sops which in our opinion are an outcome of lazy policy making. Instead, the government has cemented its commitment to a simple tax regime for companies by laying down a target of reducing corporate tax rate to 25% over next four years while simultaneously removing exemptions. This is unambiguously positive for businesses - companies can choose to pay a fair tax rate without having to indulge in legally permitted structuring. This is a tax rate that compares favourably to other geographies. Obviously at this point, this is merely a statement of intent and is subject to the fiscal consolidation road map.

The budget has elements of road map to expand the tax base by going after black money - primarily offshore but also domestic. A separate bill targeted at 'benami' transactions along with making the quoting of PAN mandatory for any purchase or sale exceeding the value of ₹ 1 lakh is a significant step up in the battle against black money. Expanding the gamut of reportable transactions and sharing of information between CBDT and CBEC when combined with the GST may drive an expansion of India's tax base and raise our Tax/GDP ratio, which is woefully low. There is also yet another attempt to monetize gold but the trick in this lies in execution.

There is a continued commitment to social sector outlays with several new schemes being announced and outlays have been maintained to the existing schemes. While some may see this as negative, we do not believe that a democratically elected government in India can absolve itself of the social security responsibility. But this commitment to social security now provides the government the basis to better target subsidies where there are significant leakages. The government has now clearly enunciated that using the combination of bank accounts, Aadhar and mobiles, they intend to change the subsidy architecture to direct benefits. They may not have quantified the tangible benefits of the same in the budget, but over the next five years there is now every reason to believe that the subsidy bill will reduce.

In the Budget speech, the government has also touched upon several issues which we list as steps in the right direction, though they do not really relate to the budget per se. A modern bankruptcy act and a contract dispute resolution process are key elements to the legal architecture of any free-market economy. We think these two laws along with a strategy for bank re-capitalization would do a lot to address the issues of stalled project investments and boost the investment cycle. Further issues related to GAAR and retrospective taxation, which have been an irritant have seen clarifications that industry has been asking for. There is greater choice that has been given to employees - they can choose between medical insurance and the state run ESIC, they have greater choice in choosing between the state run PF and a market oriented NPS and further, for incomes below a certain threshold limit, the employee contribution to EPF becomes optional. This addresses the disparity between an organized sector employee at lower income slabs taking home less salary than an unorganized or contractual employee due to mandatory deductions from income.

There are many other hits and misses in the budget but in the interest of brevity we have highlighted what we think are the changes which are structural in nature. We see the policy actions of this government over the last nine months along with the fiscal direction and policy announcements in the budget as providing long term strategic direction. There are no short term steroids available to boost growth in India at this point in time. The Chief Economic Advisor rightly described India as a 'recovering' economy and everybody will have to do their bit to help this recovery along. Macroeconomic stability has been a hard won battle over the past three years and this budget keeps us on track for a recovery. There is no change to portfolio strategy as a result of the budget. Our portfolios are positioned to benefit from a recovery in the economy. But our portfolio strategy is more balanced given the valuation changes that have taken place over the past year.

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