Macro Comment 12/22

India’s budget wins little applause

The budget for India’s fiscal year 2012/13 aims to reduce the fiscal deficit to 5.1% of GDP from 5.9% of GDP this year. With a rise in tax revenue and a more realistic growth assumption, next year’s budget seems more in reach than this year, which was overshot by 1.3% of GDP. But that is where the good news ends. In specific, leaving the subsidy scheme largely untouched creates the risk of overshooting again.

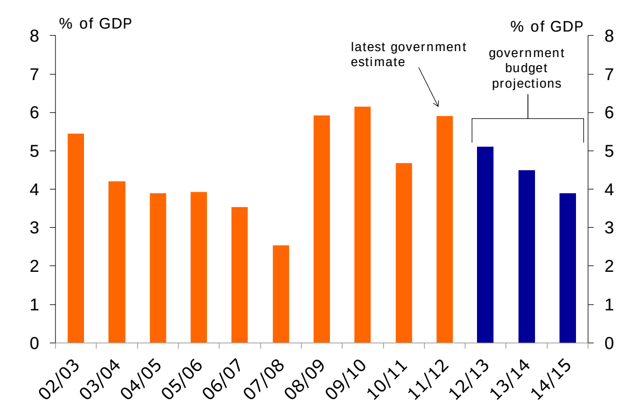
The latest estimates suggest that the central government fiscal deficit for 2011/12 (India’s fiscal year runs from April through March) will be 5.9% of GDP, thereby considerably overshooting the budgeted 4.6% of GDP. Please note that this is the central government budget. The deficits on the state budgets are expected to add about 2% of GDP to the central government deficit.

A higher than expected subsidy bill and lower than assumed economic growth are the main culprits of this year’s overshooting. Total subsidies are estimated to be 2.5% of GDP in 2011/12, rather than the 1.6% of GDP included in the budget. This was largely due to higher oil prices, which work through subsidies for cooking fuel, diesel, kerosene and fertilisers. On the other hand, the revenues underperformed, as projections were based on overly optimistic economic growth. Aggressive monetary tightening amid high inflation, stalling infrastructure projects and waning confidence in the government all weighed on activity in the current fiscal year. As a result, economic growth in 2011/12 is expected to be a little under 7% - well below the 9% target.

On Friday 16 March, Pranab Mukherjee, India’s Minister of Finance, presented the new budget for the central government. Mukherjee aims for a fiscal deficit of 5.1% of GDP in FY 2012/13 and announced a medium-term plan to bring the budget back to less than 4% in FY 2014/15.

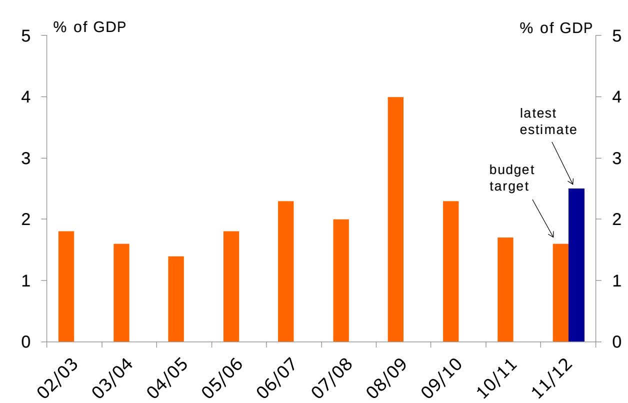
Let’s start with the upsides of the new budget. First, the increase in central excise and services tax rates from 10% to 12% is expected to bring in extra revenues of 0.5% of GDP. This partly reverses the ‘temporary’ reduction of tax rates, which was part of the fiscal stimulus package in 2008/09. Second, the assumption on economic growth underlining the budget projections is set at 7.6%, which is much more realistic than the 9% in the old budget. Economic data from the first months of 2012 have been mixed, but the slowdown seems to be bottoming out. Moreover, with inflation cooling in the past months, the

Central government deficit



Source: Ministry of Finance India

Total central government subsidies



Source: Institute of International Finance

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central bank has ended its tightening cycle. Depending on their evaluation of the new budget – and they are likely to be critical – rate cuts are expected in the next months, which would stimulate the economy. Still, 7.6% growth will be challenging, especially if the situation in Europe or the US deteriorates.

However, there are also some substantial downside risks to the 2012/13 budget. First, the minister of finance stated that he will attempt to keep the subsidy bill below 2% of GDP. However, he presented no concrete measures to achieve this target, although there are some small changes to improve targeting and reduce leakage of subsidies. Still, leaving the subsidised fuel and food prices largely untouched keeps the risk of overshooting high. Moreover, it is still rather vague what the food security bill, currently on the table, will cost. Second, the minister also hinted on going forward with the controversial proposal to extend FDI in retail, but otherwise remained very vague on the government's commitment to economic reforms. In fact, he proposed to amend the Income Tax law to allow the retroactive taxation of overseas deals involving assets in India. Coming only two months after Vodafone won a case on this issue in the Supreme Court, this latest proposal will do little good for investor confidence in the country. Considering the political headwinds the UPA coalition is facing, little progress in economic reforms is expected.

Overall, the good news is that India aims to reduce its fiscal deficit in the coming year and in the medium term. However, the government missed the opportunity to really take action, especially with regards to the subsidy bill. With the next general elections in May 2014, this year's budget would have been the best time to step up fiscal reforms. The presented budget might therefore be a step in the right direction, but the lack of concrete plans wins little applause with analysts and the market.

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