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## BUDGET 2013-14

# PLAYING BY (Y)EAR

# Contents



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# BUDGET IN SUMMARY: HALF-WAY HOUSE!

The last time Finance Minister Palaniappan Chidambaram presented the budget, India was growing at 9% and inflation was at 5%. This time around, the growth is a much-muted 5%, while inflation is at 7%. And this is the background in which Chidambaram is operating. In addition, the threat of a ratings downgrade limited any scope for fiscal stimulus to revive the economy. With national elections looming in 2014, this last full budget for the term meant Chidambaram had two options: set sights on 2014, go with guns blazing and devise a populist budget, or retain prudence and economic sense, and make a budget that takes care of the long term. He chose the second one.

Given the limited resources at his disposal, expectations from the finance minister were low. Domestic and foreign investors were not anticipating an encore of the "Dream Budget of 1997". There were regular wish lists:

a. Reduce the fiscal deficit, which is crowding out private investment and driving up interest rates
b. Reduce the current account deficit – Energy and gold imports have driven the current account deficit to 5% of GDP, which is double the government's long-intended comfort level of 2.5%
c. Generate growth – Get economic growth back to 9% levels by providing incentives for consumption and investment
d. Ensure a stable taxation regime – Undo the follies of his predecessor, revise the direct tax regime and hasten the passage of the GST (which, by some estimate, can boost GDP growth by 2%)

In the face of such expectations, the finance minister presented what must be called a responsible fiscal budget, eschewing the populist agenda of the past. The improving situation in the past couple of months allowed the finance minister enough wiggle room to increase public spending by 16%, increasing outlays on social as well as key economic sectors. This should translate into economic growth of 6.1–6.7% in FY 2014 and keep fiscal deficit under check at 4.8% of GDP.

As promised, the fiscal deficit was contained at 5.2% of GDP in 2012-13—the target for 2013-14 is 4.8%—laying the path for fiscal consolidation. This was not a surprise with the ratings downgrade hanging like the Sword of Damocles. The estimates are based on assumptions of reduction in expenditure and higher dividends from state-run companies. However, there is scope for slippage with regard to tax collections, spectrum proceeds and the higher-than-estimated subsidy burden provided in the budget.

On the downside, Mr Chidambaram presented no measures to curb the current account deficit. The government has kept import duties on gold unchanged for the present. This is perhaps a prudent move because increase in duties could promote the illegal imports of gold and the consequent revenue erosion could far outweigh the gains. The introduction of incentives for investing in gold bonds would have channeled investments fuelling the current account deficit into savings. There were no far-reaching reforms introduced to reduce dependence on oil and coal, and simultaneously increase the share of renewable energy. Strong incentives to promote alternative energy would have laid the foundations for energy independence and reduced the current account deficit in the medium term.

To revive economic growth, it was necessary for the Union budget to contain provisions to boost consumption (which accounts for 70% of India's GDP), savings and investment (there has been a decline in savings and investment rates in recent years). No changes were effected in the personal taxation structure (rates or slabs) to promote domestic consumption and investment. Except for the one-time 10% surcharge on the super-rich, there were no measures to boost consumption and investment among salaried employees who constitute a significant tax base.

For the corporate sector, too, the budget held no goodies in terms of investment incentives; instead, proposals for higher taxes were introduced.

## Channelizing investments into capital markets

The new budget attempts to remove ambiguity regarding the definition of foreign direct investment

(FDI) and foreign institutional investment (FII). As per the proposal, if a foreign investor has a stake of 10% or less in a company, it will be treated as FII and, where an investor has a stake of more than 10%, it will be treated as FDI. Other related measures include:

- Allowing FIIs to participate in the exchange traded currency derivative segment to the extent of their Indian rupee exposure in India
- Permitting them to use their investment in corporate bonds and government securities as collateral to meet their margin requirements
- Permitting small and medium enterprises to list on the SME exchange without being required to make an initial public offer. However, the issue will be restricted to informed investors
- Allowing stock exchanges to introduce a dedicated debt segment on the exchange. This is targeted at improving debt markets
- Reducing the securities transaction tax (STT). STT on mutual fund redemptions at fund counters has been decreased from 0.25% to 0.001%. On ETF sale on exchanges, it has been reduced from 0.1% to 0.001%

However, the incentives provided were far and few and are unlikely to boost the flagging investor sentiment. Predictably, the market tanked 291 points on the Sensex and, breaching the psychological level of 19,000, closed at 18,862; the lowest level so far in 2013. FIIs sold heavily after they interpreted the government's intent to study the origin of funds from tax havens such as Mauritius.

The one aspect where the budget was successful was in the sphere of taxation. The finance minister had promised investors a stable tax regime. He also promised positive steps to ensure the positive implementation of the Goods and Service Tax, which is hanging fire due to the lack of consensus between the Centre and the States. In his budget speech, the finance minister mentioned that the Direct Tax Code will be introduced in the Budget session of the Parliament. It is expected to ensure greater transparency and compliance.

The controversial General Anti Avoidance Rule (GAAR) would be effective from April 2016, providing relief to overseas investors. The budget moved closer to the implementation of the Goods and Services Tax (GST) by allocating INR9000 crore for the first installment of the balance of GST payment. This was a pragmatic step as the compensation to be provided was the bone of contention hampering discussions. However, with the exception of a token announcement on framing and introducing the bill within the next few months, there was no enunciation of a roadmap for GST implementation.

Reactions to the budget are low-key since the demands of investors have been partly met. Positive action was taken on reducing the fiscal deficit and rationalizing the taxation structure. However, no positive steps were taken to reduce the current account deficit or revitalize GDP growth.

In sum, the budget was a half-way house, meeting some expectations but failing to deliver on other promises. Some analysts and pundits called it a non-event and a disappointment; the opposition, as expected, has panned it on a number of counts. But, given the constraints faced and the resources at hand, Mr Chidambaram maneuvered it deftly.

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# EXTERNAL IMBALANCES: GOOD INTENTION, LIMITED RESPITE

While challenges on the domestic front remain high, the threat of external imbalances is more pronounced than ever before. The current account deficit remains precariously large. After hitting a high of 4.3% of GDP in FY 2012, it increased to 5.3% during the second quarter ended September 2012, rendering the country vulnerable to volatility in the international financial system. Indeed, the rating agencies renewed their concerns on India's susceptibility to external shocks, especially commodity price trends and a depressed macroeconomic environment.

The widening current account deficit has exerted significant downward pressure on the rupee which further makes imports expensive, turning this into a vicious cycle. According to the government's estimates, India would need around USD75 billion to bridge the current account deficit. The government aims to achieve this through a mix of foreign investments, both FDI and FII, as well as external commercial borrowings. This would be challenging as FDI inflows into India fell nearly 46% to USD16 billion during April–November 2012. Nonetheless, a rise in portfolio investments, which breached USD20 billion during 2012, could alleviate the situation.

One of the key aspects of the budget was also the spending rationalization exercise, which accorded a high priority to keeping the fiscal deficit under control. A host of measures, including reduction in fuel subsidies and cut in planned and non-planned expenditure, enabled the government to restrict the deficit to below 5.2% of GDP. It has further reduced fuel subsidies for the current year to just under USD12 billion as against the previous year's USD18 billion, while overall subsidies have been capped at around USD40 billion. However, the additional spending (totaling USD2 billion) on account of the food security bill, over and above the USD16 billion marked under food subsidies, could throw wind to the caution.

Lastly, the inflationary situation appears to be easing with both wholesale and consumer prices coming down from their highs, thanks largely to the continued monetary tightening by the Reserve Bank of India (RBI). The WPI inflation has fallen to just under 7% amid easing commodity prices and fall in the non-food manufacturing sector. The government aims to bring it down to around 6.2–6.6% by March 2013; this would give the central bank more maneuvering room to kick-start the Indian economy.

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# INFRASTRUCTURE: SOME MOMENTUM AT LAST

The finance minister finally provided some impetus to the infrastructure sector. A policy paralysis and grounded projects have hindered infrastructure development in the country. In the wish-list for infrastructure sector were:

- Industry status
- Increased spending
- Ease of access to low-cost financing
- Measures to improve private sector participation
- Greater availability of coal
- Clarity on the working of the Cabinet Committee on Investments
- Tax holidays/incentives for high-value infrastructure investments

In spite of the constraints of a high fiscal deficit, the finance minister has promised investments in infrastructure. Given the focus on job creation, infrastructure spending has received a boost. Budget 2013 provides for several, if not all, of the measures on the infrastructure wish-list. The 12th Five-Year Plan calls for infrastructure expenditure of approximately USD1 trillion. Financing for this huge outlay was, therefore, a key talking point.

## Regulatory changes

- A regulator body for the road sector will be set up. This should help clear regulatory hurdles faster; the body will oversee land acquisition disputes and review the performance of the National Highways Authority of India (NHAI).
- Committees will be set up for fast-tracking not only new projects, but also stalled projects.

## Financing/Fiscal measures

- Some financial institutions will be allowed to raise up to USD9 billion in long-term tax-free bonds. Institutions allowed to issue tax-free bonds are expected to raise USD4.5 billion in 2012-13 compared to USD5.4 billion in 2011-12.
- Credit enhancement from India Infrastructure Finance Company Limited is expected to help provide long-term, low-cost debt for projects.
- The rate of tax paid to non-resident investors in infrastructure bonds has been kept at last year's 5% (cut from 20% previously). This is a measure to encourage foreign currency investments in infrastructure bonds.
- The investment allowance of 15% for capital expenditure bodes well for infrastructure development.

## Roads

- Nearly 3,000-km of road projects have been announced in 2013-14 across states including Andhra Pradesh (eastern India); Uttar Pradesh (central India); and Gujarat, Maharashtra, and Rajasthan (western India).
- The government will seek funding from Asian Development Bank and World Bank to build roads to connect north eastern India with Myanmar.

## Ports

- Two new major ports would be built in eastern India: one at Sagar, Andhra Pradesh, and another in West Bengal.

## Power sector

- Tax deductions extended for an additional year
- Government to set up 75 MW windmill plants
- Electrification of 1,200 km of roads to be completed

## Industrial corridors

- Two towns along the Delhi-Mumbai industrial corridor are proposed to be developed.
- The government is pushing for two industrial corridors: Chennai-Bangalore and Mumbai-Bangalore.
- Around USD1.6 billion has been allocated for improving connectivity between ports and mines.

- The Railway budget, announced on February 26, proposed five new freight corridors in addition to the two currently being implemented.
  - The Eastern corridor (covering 1,839 km) will connect Dankuni in east India with Ludhiana in north India.
  - The Western corridor (covering 1,499 km) will connect Mumbai's JN Port with Dadri/Rewari near Delhi.
  - Studies are underway for five other corridors: Chennai-Bangalore, East-West Corridor (Kolkata-Mumbai), North-South Corridor (Delhi-Chennai), East Coast Corridor (Kharagpur-Vijayawada) and Southern Corridor (Goa-Chennai).

## Energy

- Oil and gas blocks awarded under the New Exploration Licensing Policy will be approved.
- The government will move towards a revenue-sharing model as opposed to the current profit-sharing model.
- The 5 million tonnes/year Dabhol LNG terminal will be fully operational in 2013-14.
- The natural gas pricing policy will be reviewed.
- Shale gas exploration will be encouraged.
- Duties on steam and bituminous coal will be equalized at 2% customs duty and 2% countervailing duty.

To encourage domestic production of coal, public-private partnerships (PPP) with Coal India Ltd could be allowed.

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# SECTORAL IMPACT ASSESSMENT

## AUTOMOTIVE

**Expectation:** The budget was expected to maintain a status quo or decrease excise duties to support the demand in the auto industry that has been impaired by rising fuel prices and uncertainty in incomes

**Budget Proposals:** Excise duty and the peak rate of basic customs duty for automobiles are unchanged. Non-taxi SUVs will face an excise duty of 30%, up from 27%, while imported luxury cars will have a customs duty of 100%, up from 75%.

**Impact:** With no change in basic customs duty for automobiles, the status quo will be maintained in the auto industry. However, sales of SUVs, which are growing at 16%, will take a hit, affecting the market. Increase in excise duty on imported automobiles will contain the imports.

## AVIATION

**Expectation:** For the loss-ridden Indian carriers that have failed to attract much investment from global carriers, despite the recent opening up of the sector, the big expectation was some relief on the air turbine fuel (ATF) and manufacture, repair and overhaul (MRO) taxes.

**Budget Proposals:** The budget has proposed to provide a plan outlay of INR5,000 crore for the debt-ridden Air India and duty concessions for the aircraft manufacture, repair and overhaul (MRO) industry.

**Impact:** While reduction in MRO taxes is welcome, there is disappointment regarding the high ATF taxes.

## BANKING AND FINANCE

**Expectations:** The budget was expected to propose the recapitalization of state-owned banks for complying with Basel III regulations.

**Budget Proposals:** In line with expectations, the budget proposes to recapitalize state-owned banks for complying with Basel III regulations with a package of INR2517 crore. Housing loans have also got a boost with the proposal of income tax benefit for first-time buyers and increase in the budget for the Rural Housing Fund to INR6000 crore.

**Impact:** The budget has met expectations and given a boost to the rural and housing loan sectors.

## POWER

**Expectations:** For the critical power sector that stares fuel availability issues resulting in low plant load factors and delayed projects, the budget was expected to provide measures to revive the industry.

**Budget Proposals:** The budget has proposed issuing tax-free bonds of INR50,000 crore and a credit enhancement scheme from IIFCL and ADB. It has also sought to extend the sunset clause to avail of the 10-year tax holiday by a year and increased the customs duty on imported steal coal to 2%. In addition, it has proposed generation-based incentives worth INR800 crore for wind energy projects. Furthermore, it has proposed that the PPP framework be adopted for coal production.

**Impact:** Adopting the PPP framework for coal production may solve the coal supply problems at power plants in the long term.

## OIL AND GAS

**Expectations:** The budget was expected to address the issue of under-recoveries in the oil sector.

**Budget Proposals:** The budget has proposed a shift from a profit-sharing to a revenue-sharing exploration policy and sought a review of the natural gas policy.

**Impact:** For the oil & gas industry, plagued by high crude oil prices, the revenue-sharing exploration policy could remove cost ambiguities and approval delays.

## INFRASTRUCTURE

**Expectations:** For a sector that is fraught with delays and slowdown, there were many expectations from the budget on the investment and policy fronts.

**Budget Proposals:** The budget has proposed an independent regulatory authority for the roads sector and that tax-free infrastructure bonds for up to INR50,000 crore be issued. In the first half of the year, about 3000 km of highways are expected to be awarded. Two new major ports in West Bengal and Andhra Pradesh as well as a new outer harbor in Tamil Nadu have been proposed to increase port capacities. For the steel industry that faces weak demand and low margins, the budget has proposed zero excise duty, down from 7.5%, on galvanized steel sheets.

**Impact:** An independent regulatory authority will speed up projects, a primary factor for slow growth and investment. Due to this factor as well as the boost to the infrastructure and housing loan sectors, demand and growth in the cement and steel sectors could increase.

## RETAIL

**Expectations:** The retail sector was looking forward to more clarity on the roadmap for GST implementation, since GST is expected to significantly reduce the indirect tax burden on the sector by removing the cascading taxes.

**Budget Proposals:** The budget has proposed zero excise duty on readymade garments and a 6% duty on mobile phones costing more than INR2000. It has appealed for a consensus to facilitate the drafting of bills on constitutional amendment and GST legislation.

**Impact:** Until there is some clarity on policies, hesitation to invest in the sector will persist.

## TEXTILES

**Expectations:** Following the slowdown in demand in the global and domestic markets, the budget this year was expected to add measures that would increase demand.

**Budget Proposals:** The budget has proposed to reintroduce zero excise duty on readymade garments, lower the customs duty on textile machinery and parts to 5% from 7.5%, and increase the customs duty on imported raw silk to 15%. It has also increased the budgetary allocation to INR4,631 crore and extended the Technology Upgradation Funds Scheme (TUFS) with an allocation of INR2400 crore.

**Impact:** The relaxation in duties on readymade garments and textile machinery coupled with the extended TUFS should benefit the sector.

## REAL ESTATE

**Expectations:** For a sector that is fraught with delays and slowdown, there were many expectations from the budget on the investment and policy fronts.

**Budget Proposals:** The budget has proposed additional tax benefits for first-time buyers availing home loans of INR25 lakh, an Urban Housing Fund of INR2000 crore and increased allocation for the Rural Housing Fund by 50% to INR6000 crore. It has also proposed that service tax be reduced to 70% from 75% for homes and flats having a carpet area of 2,000 square feet or more, or value of INR1 crore or more.

**Impact:** The budget will have a positive impact on the affordable homes segment. Demand and construction are expected to increase.

## FMCG

**Expectations:** Despite a slowdown in urban markets, the rural sector has seen an upswing, and the budget was expected to support this growth.

**Budget Proposals:** The budget has proposed an increase in the allocation of resources for rural development. The excise duty on cigarettes has been increased by 18%.

**Impact:** The allocation of resources for rural development is expected to aid prosperity and demand in these areas. The increase in the excise duty on cigarettes is expected to affect demand marginally if it is passed on to consumers.

## About Aranca

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