Research

CRISIL
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Bolstering Bharat

Budget Analysis

February 2017

Batting for Bharat

The imprimatur of Bharat is unmissable in the budget.

Reviving fortunes in the hinterland by bolstering the agricultural economy and rural infrastructure seems to be the primary motivation of the Union Budget announcements this time, as evinced in higher allocations for MNREGA and the Pradhan Mantri Awas Yojana, among others.

Increase in credit availability, the focus on micro-irrigation and dairy-related activity, making farm incomes more predictable – all will have an upshot: it will bolster rural incomes and support consumption demand, which should benefit makers of consumer goods and durables, two-wheelers and tractors.

Increased outlays on roads, housing, sanitation and electrification through various schemes would make a difference in rural livability. In the process, there would be significant opportunity to the construction, cement and metals sectors.

In terms of infrastructure build-out, the focus is largely on transportation, especially railways and roads. There is a nearly 10% increase in budgetary allocation to infrastructure, including 24% increase for national highways. Upgrading connectivity and improving logistical efficiencies have excellent multiplier effects.

For urban India, there is an 80% increase in allocation towards metro rail. While new policy framework to encourage private sector investments in the sector is expected to facilitate faster execution of projects, land acquisition and multiplicity of approvals remain key challenges.

This focus on transport infrastructure is expected to boost construction, engineering, metals, cement, and logistics sectors. Over the longer term it should help reduce logistics costs and improve efficiencies, both of which are critical for the manufacturing sector to be competitive.

Investment in building a strong broadband digital infrastructure is set to improve coverage and quality of service in rural India. This is critical to the expansion of the digital economy, especially for financial transactions, government welfare schemes and education. Allocation under the Bharat Net programme has been budgeted at Rs 100 billion, which marks a near-two-thirds increase over the previous year. This, in turn, provides a significant opportunity for the telecom sector.

The various initiatives announced for the real estate sector are expected to ease funding for affordable housing projects, provide tax relief to developers with unsold inventory, and support demand on the back of a softening rate environment. Deferment of payment of capital gains in case of joint development agreements is expected to benefit land owners, making them a preferred model of development.

The net market borrowings of the government has been restricted to Rs 3.48 trillion for next fiscal, much lower than the Rs 4.25 trillion previously. This is a positive from a bond market perspective.

Concessional tax rates for external commercial borrowings and capital gains benefits for masala bonds will support fund-raising.

The government has chosen prudence over populism with a budgeted fiscal deficit target of 3.2% of GDP. Moreover, fiscal arithmetic appears to be broadly credible, though divestment target and GST implementation could cause hiccups.

In fiscal 2018, we expect a gradual pick-up in GDP growth to 7.4% from ~7% in fiscal 2017 as investment cycle is expected to remain weak and consumption demand will likely pick up only moderately despite reduction in tax rates and softer interest rates.

One big miss in the budget, however, is the lack of roadmap to resolve the banking sector asset quality stress and capital woes.

All in all, under the current circumstances, the budget has done a good job of furthering government's agenda on financial inclusion and enhancing economy's long-term growth potential.

Economy analysis

Mildly growth supportive

The Union Budget 2017 has performed a balancing act. With an eye to reducing deficit and simultaneously improving growth prospects, the Budget refrained from stretching its fiscal coffers to give a steroidal push to the economy. Yet, sectors like transport and affordable housing received a shot in the arm, which in turn, is expected to push demand in sectors such as cement and steel, generating positive multiplier effects in employment and incomes. This, to an extent, will help alleviate some stress in rural areas which were hit hardest by the demonetisation drive. Also, the reduction in individual income tax rates (brought down to 5% from 10% for those in the income slab of Rs 0.25-0.5 million) will raise the purchasing power. Nearly, 20 million people who currently declare income in this bracket will benefit from the change.

Yet, the expected push to consumption in fiscal 2018 from budgetary announcements will only be mild, and we expect GDP growth to rise marginally to 7.4%, up from 7% in fiscal 2017. Normal monsoons, softer interest rates and inflation, and pent up demand (demand postponed due to the demonetisation) will support consumption growth next fiscal. Higher domestic demand will put to use spare capacity in sectors such as cement, steel and consumer durables, which will help regain appetite for industrial investment in the economy. However, overall infrastructure investments will take longer to pick-up, especially given the private sector's inability to invest amid high leverage and impaired balance sheets. Investments have been steadily falling – to 29% of GDP in fiscal 2017 from 34% in fiscal 2012. The government's investment, although encouraging, has not been enough to significantly raise overall investment in the economy. Overall investments, therefore, we believe will only see a pick-up in fiscal 2019, provided GDP growth stays on track.

The government's stance on maintaining focus on structural reforms remains clear. The steady push to Jan Dhan, Aadhar and Mobile (JAM) platform and digitisation supported by reforms like Goods and Services Tax (GST) and demonetisation have the potential to raise financial savings, increase organised play, and contribute to higher GDP growth and improved tax collections over the medium term.

Indian economy outlook

	FY16	FY17F	FY18F	
GDP (y-o-y %)	7.9	7.1*	7.4	Normal monsoon, lower borrowing costs, relatively benign inflation, pent up demand due to demonetisation and a mild budgetary support to incomes to drive consumption growth. Meanwhile, higher government spending on transport and housing will push investments.
CPI inflation (%, average)	6.0	4.7	5.0	Inflation could see a mild pick-up as consumption sees a revival and sticky components of inflation look further up. However, expectation of a normal monsoon will keep food inflation under control.
Fiscal deficit (% of GDP)	3.9	3.5	3.2	Wider tax net and improved compliance on account of demonetisation, income declaration scheme, GST implementation and disinvestment revenues to help trim the fiscal deficit.
10-year G-sec yield (%, March-end)	7.5	6.5	6.6	A lower fiscal deficit target would result in restrained market borrowings by the government. However, with some upside risks from inflation, yields could move northwards.

Note: F=CRISIL Forecast, *CSO advance estimate

Source: RBI, CSO, Ministry of Finance, Ministry of Commerce and Industry, CRISIL Research

Government maintains focus on fiscal consolidation

The government decided to use some leeway provided by the N K Singh committee report and kept the fiscal deficit target for fiscal 2018 at 3.2% of GDP, as opposed to the Fiscal Responsibility and Budgetary Management (FRBM) target of 3%. "The Committee has also provided for 'Escape Clauses', for deviations up to 0.5% of GDP, from the stipulated fiscal deficit target", the Budget said. This would create a marginal extra spending space of Rs 337 billion for the government in fiscal 2018.

At the same time, government has committed to achieving the 3% fiscal deficit target in fiscal 2019. Apart from broad measures such as implementation of GST and push to digital transactions post demonetisation, which would help increase the tax net/compliance, the government announced other steps that could improve direct tax compliance:

- Reduction in the tax rate for the assesses in the income slab Rs 0.25-0.5 million to 5% from 10%: The lower tax rate should encourage people to enter the tax net and comply.
- A simple one-page form to be filed as income tax return for the category of individuals having taxable income up to Rs 0.5 million, other than business income.
- Individuals belonging to the above category, who file income tax returns for the first time, will not be subject to any scrutiny in the first year, unless there is specific information available with the income tax department regarding his/her high value transactions

While the government managed to achieve a fiscal deficit target of 3.5% in fiscal 2017, the economic cycle forced the government to go easy on fiscal consolidation in fiscal 2018. This appears justified as this budget was expected to address the sharp slowdown in GDP growth that has followed demonetisation, which the Central Statistics Office had estimated to slow down to 7.1% in fiscal 2017, from 7.9% in fiscal 2016.

Theoretically, the fiscal deficit target should be counter-cyclical which means there should be a flexibility to run higher fiscal deficit when growth is slow and vice versa. According to a 2016 IMF paper[1], "Fiscal space is a multi-dimensional concept reflecting whether a government can raise spending or lower taxes without endangering market access and debt sustainability. Making such a determination requires a comprehensive approach considering, among other things, initial economic and structural conditions, market access, the level and trajectory of public debt, present and future financing needs, and dynamic analysis of the liquidity and solvency of the fiscal position under alternative policies. Balancing these considerations involves careful analysis and judgment."

By sticking to a higher level of fiscal deficit, the government seems to have accounted for a) initial disruptions on account of GST, which is likely to be adopted by July 1, and b) lack of some of the transient revenue sources from the past such as petroleum excise and spectrum revenues.

[1] Assessing fiscal space: An initial consistent set of considerations, IMF, December 2016

Government balances the fiscal math…

On the fiscal front, the Budget appears to have pulled off a balancing act:

- The fiscal deficit target of 3.2% of GDP for fiscal 2018 looks manageable; reducing it to 3% subsequently would require diligent implementation of measures to improve tax net
- Government's tax collection assumptions appear reasonable, despite the anticipated short-term disruptions on account of GST implementation mid way next fiscal
- A slip on disinvestment receipts may pose a challenge of up to 10 bps to the fiscal deficit target for fiscal 2018

…provided it got its assumptions right

Are there any risks in achieving the fiscal deficit target for 3.2%?

While most of the government's revenue assumptions appear to be prudent (see table below), there are possibilities of mild disruption to the fiscal math. Some factors to watch out for:

- Growth assumptions: The government's 3.2% fiscal deficit target is based on the assumption of an 11.75% nominal GDP growth in fiscal 2018. If the demonetisation impact were to spill over to next fiscal and the initial disruptions from the GST implementation are higher than anticipated, achieving that could be challenging. Nominal GDP growth in fiscal 2017 was 10.2% without factoring in the demonetisation impact, and this may get revised down further. CRISIL Research's nominal GDP growth forecast for fiscal 2018 is 11.6%.
- Excise duties: The overall excise collection targets are moderate, and on oil too, excise revenue budgeted appears to be achieveable. Government has estimated oil excise revenue to rise from Rs 2,258 billion in fiscal 2017 to Rs 2,400 billion in fiscal 2018. However, rising oil prices[2] may force the government to roll back some of the excise hikes of the past and this target may be difficult to achieve.
- Disinvestment receipts: While government expects to achieve 80% of its disinvestment target of Rs 565 billion in fiscal 2017, actual proceeds from disinvestment so far this fiscal are only about 50% of the budgeted. A disinvestment target of Rs 725 billion (a 60% rise) for fiscal 2018 still appears huge.

Major tax heads

	Rs. Billion				Growth (%)				
	FY15	FY16	FY17 RE	FY18 BE	FY15	FY16	FY17 RE	FY18 BE	Average FY15-FY17
Gross Tax Revenue	12,449	14,596	17,032	19,116	9.3	17.2	16.7	12.2	14.4
Corporation Tax	4,289	4,532	4,939	5,387	8.7	5.7	9.0	9.1	7.8
Income tax	2,657	2,876	3,531	4,413	11.7	8.2	22.8	24.9	14.3
Customs	1,880	2,103	23,170	2,450	9.3	11.9	3.2	12.9	8.1
Union Excise Duties	1,900	2,881	3,874	4,069	12.1	51.7	34.5	5.0	32.7
Service Tax	1,680	2,114	2,475	2,750	8.5	25.9	17.1	11.1	17.2

Source: Budget documents, CRISIL Research

[2] CRISIL forecast oil price at Rs 50-55/barrel in fiscal 2018, up from Rs 42-47/barrel in fiscal 2017

Debt sustainability continues to remain a challenge

As the government has relaxed its fiscal consolidation stance and postponed achieving 3% fiscal deficit target to fiscal 2019, it must not lose sight of debt sustainability. Government's primary deficit in fiscal 2017 stood at 0.34% as opposed to the budgeted 0.27%. True, central government's debt ratio (debt to GDP) has seen some improvement in the last two fiscals, however, there is a long way to go to achieve the targeted debt ratio to 40% (as suggested by the N K Singh committee). With states combined, this ratio must be brought to below 60%.

While the government has taken a number of steps (demonetisation, focus on digitalisation, GST) to structurally improve the fiscal space, the government will have to persistently pursue these to lift the tax/GDP ratio in the coming years to ensure medium term fiscal sustainability, and reduction of debt/GDP ratio (See Box 1).

Box 1: The nuts and bolts of debt/GDP

Centre	FY13	FY14	FY15	FY16	FY17 RE	FY18 BE
Debt/GDP (%)	47.3	47.4	47.0	48.0	46.7	44.7
Average interest cost 'i'	6.4	6.7	6.6	6.6	--	--
Nominal GDP growth 'g' (%)	13.91	13.28	10.78	8.71	10.2@	11.75
Primary deficit/GDP (%)	1.78	1.14	0.87	0.68	0.34	0.14

Centre + State	FY13	FY14	FY15	FY16*
Debt/GDP (%)	66.6	66.8	67.1	68.6
Average interest cost 'i'	7.3	7.5	7.5	7.4
Nominal GDP growth 'g' (%)	13.91	13.28	10.78	8.71
Primary deficit/GDP (%)	2.31	1.91	2.23	1.60

*state numbers are budget estimates, @CSO estimate

Source: Finance Ministry, RBI, CRISIL Research,

The debt dynamics equation suggests that for bringing down the debt/GDP ratio: a) GDP growth must be higher than interest rates and b) primary account should be in surplus.

It is clear from the above table that the stickiness of debt ratio up to fiscal 2016 was owing to narrowing gap between growth and interest rates (nominal GDP growth rate came down sharply but average cost of debt remained sticky) and inability of the government to run a primary surplus.

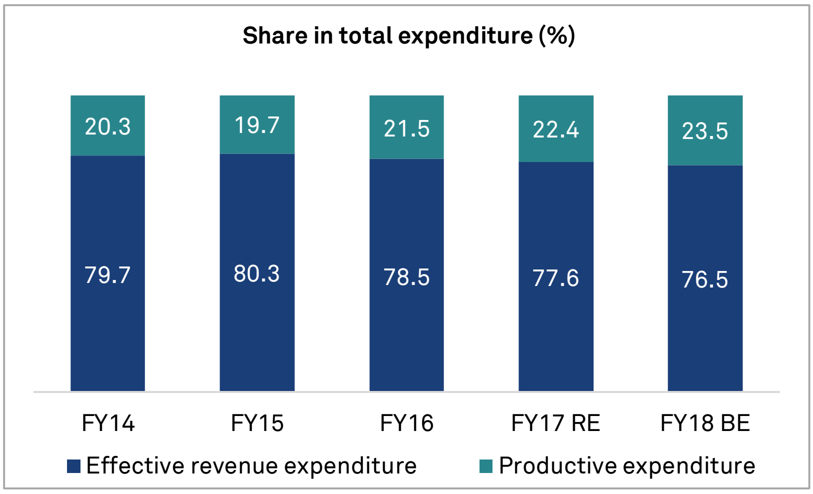
In the evolving scenario, the central government will have to run a surplus on the primary account (obtained after netting interest payments from fiscal deficit) to bring down the debt ratio. Viewed from this lens, the government's fiscal space will continue to be limited.

Quality of spending to improve in fiscal 2018

Even with demonetisation weighing on the economy, the government has chosen to move towards further moderation in spending for fiscal 2018. Quality of spending will improve in Budget 2018 as capital expenditure is budgeted to grow 10.7% over fiscal 2017 compared with revenue expenditure, which will grow 5.9%.

Revenue expenditure appears weaker because of a high base, given that it had grown 12.8% in fiscal 2017. Nevertheless, the share of revenue expenditure in GDP will decline to 1.9% in fiscal 2018 from 2.1% in fiscal 2017. Within total expenditure, the share of effective revenue expenditure (revenue expenditure excluding grants to states for creation of capital assets) will decline marginally in favour of productive expenditure (capital expenditure including grants to states for creation of capital assets).

Expenditure mix improves further in Budget



Note: Grants to state governments for creation of capital assets have been excluded from revenue expenditure and included in productive expenditure

Source: Budget documents

Budget aims to give consumption boost through employment generation

Even though consumption received a jolt following demonetisation, the government refrained from giving a cyclical push through higher subsidies. Rather, it chose to lift consumption by increasing investment in activities generating employment. Allocation for employment-generating schemes is proposed to increase 2% in fiscal 2018. However, this is less than the 37.6% growth in fiscal 2017. Compared with subsidies, such measures not only boost consumption in the short term, but also create assets that raise growth over the medium term.

Among employment-generating schemes, the highest share of spending is proposed to go to MNREGA. In fiscal 2017, the government spent nearly 23% more than budgeted under the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGA), primarily to cushion the rural economy from the impact of demonetisation. Accordingly, the Budget has only allocated about 1.1% more funds to the same in fiscal 2018.

In addition, the government has increased allocation for construction activities such as roads and affordable housing. Both are highly labour-intensive and employ low-skill workers. Affordable housing under the Pradhan Mantri Awas Yojana (PMAY) has received special focus, for which the government has allocated Rs 290 billion, an increase of 38.7% over fiscal 2017. Allocation for road transport has increased 11% in fiscal 2018. The allocation for the Pradhan Mantri Gram Sadak Yojana has been kept at Rs 190 billion, same as in fiscal 2017.

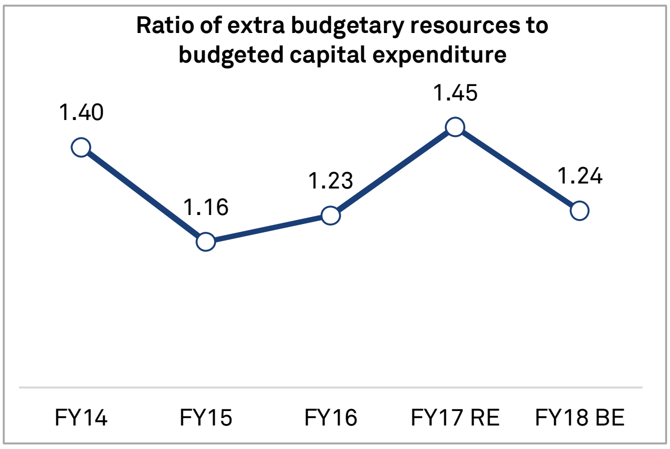
What has the Budget done to raise investment?

The Budget proposes to increase capital expenditure by 10.7% on-year in fiscal 2018, similar to the 10.6% increase in fiscal 2017. The Budget's continued push to capital spending is welcome at a time when the Central Statistical Organistion estimates fixed investment to fall 0.2% on-year in fiscal 2017. Historically, it has been seen that higher public investment in India has led to higher private investment with a lag.[3] Hence, the Budget's push to capital expenditure can help revive private investment over time.

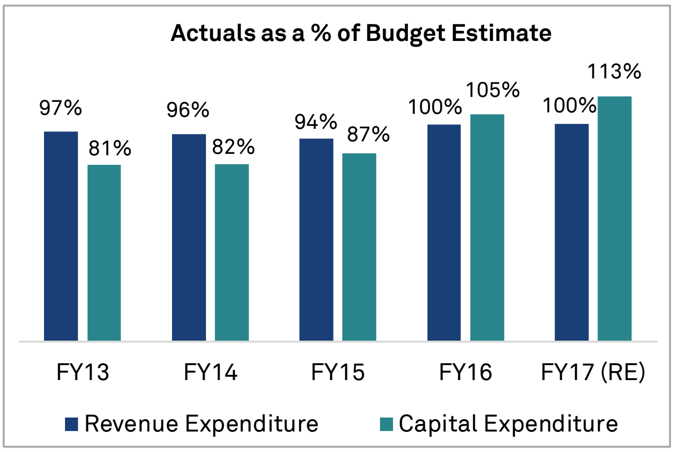
The government continued with its focus on infrastructure spending, which is budgeted at Rs 3.96 trillion in fiscal 2018, an increase of 10.5% over the previous fiscal. Within infrastructure, the sectors that received the highest allocations were rail, road transport, and rural development. Over the previous fiscal, budgetary allocations for power increased 51%, road transport 31%, Railways 19%, and shipping 16%. On the other side of the spending spectrum, civil aviation saw its budgetary allocation drop 29%.

For its capital spending, the government continues to seek support from public sector enterprises (PSEs) through internal and extra budgetary resources (IEBR). However, compared with fiscal 2017, the dependence on IEBR in fiscal 2018 has been reduced marginally, in favour of budgeted capital expenditure. The resources planned to be raised by PSEs have also declined 5% in fiscal 2018 over fiscal 2017.

Reduced dependence on public sector enterprises for capital spending



Both revenue and capital expenditure meet their targets in fiscal 2017



Source: Budget documents

Although the government depends more on public sector enterprises for infrastructure spending, it has been seen in the past that the capacity of PSEs to execute the allocated expenditure has been low. This is particularly observed in roads and railways. In the former, only 37% of IEBR allocation was utilised in fiscal 2015. While the IEBR component surpassed budgetary allocation in fiscal 2016, 65% of the allocation was utilised.

However, fiscal 2017 saw a marked improvement in actual spending, where IEBR overshot its original target by 2%. Moreover, government capital expenditure supassed its 2017 Budget target by 13% for fiscal 2017.

[3] CRISIL Economy Quick Byte: *Can the Budget revive investment?* January 2017.

Further, to improve the investment climate, the government has:

- Decided to abolish the Foreign Investment Promotion Board in fiscal 2018
- Proposed to exempt Foreign Portfolio Investor Category I & II from indirect transfer provision
- Proposed a common application form for registration, opening of bank and demat accounts, and issue of PAN for Foreign Portfolio Investors (FPIs), which will improve the ease of doing business

Trying to soothe the pain in the rural sector

The Budget looks to lower the pain caused by demonetisation to incomes and spending in the predominantly cash-driven rural sector.

- Farm sector allocation is 6% higher over a 118% rise in fiscal 2017, which has made way for spending on interest subsidy, irrigation, and crop insurance.

  Crop insurance: The government proposes to raise coverage under the Fasal Bima Yojana scheme to 40% in fiscal 2018 and 50% in fiscal 2019. So far the progress is encouraging, with 26.5% of all farmers covered as of December 2016. However, it remains to be seen if the insurance cover per farmer per crop is adequate.

  National agricultural markets (e-NAM): The Budget proposes to also increase the coverage of eNAM to 585 from the current 250. However, critical to this is that states reform their APMC Acts (so far, only 11 states have amended their Acts) and also, over time, delist perishables from APMCs.

While the announced measures will provide some support, the policy push to revive the agriculture sector and boost profitability is far from adequate. Today, the four most pressing issues facing the agriculture sector are: (i) stagnant and low productivity, (ii) lopsided cropping pattern, (iii) poor rural infrastructure, and (iv) inefficient markets. Yields of major crops such as rice and wheat have barely risen 1% annually in the past two decades, while the yield for pulses is nearly 30% below world average.

- The non-farm sector continued to draw attention, especially now that incomes have been hurt by demonetisation. The shift towards higher non-MGNREGA spend is evident within rural budgetary spend for the third consecutive year.

  Rural construction: As in other years, continued support for rural roads construction (under the PM Gram Sadak Yojana) as well as a push for rural housing (PMAY) will help infrastructure creation and employment generation. About 15% of the total spending on rural development is dedicated to roads (Rs 190 billion), and although budget allocation is unchanged this time, the past two years saw significant increases. Spending under PMGSY rose 85% in fiscal 2016 and 4% in fiscal 2017, while the pace of construction has accelerated to 133 km per day from 100 km two years back. In the same spirit, the 44% increase in allocation to rural housing will also help push job creation and create demand in the rural economy.

  A study on the consumption patterns of workers benefitting from the rural roads programme shows workers tend to allocate a larger proportion of their discretionary spending on durable goods (new and second hand), education, paan, tobacco, intoxicants, toiletries, and household commodities. The sectors producing them, therefore, can expect some boost due to budgetary measures.

MGNREGA: In fiscal 2017, the government spent nearly 23% more than budgeted under the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGA), primarily to cushion the rural economy from the impact of demonetisation. Accordingly, the Budget has only allocated about 1.1% more funds to the scheme.

For the government, pushing rural construction - of roads as well as through the MGNREGA scheme - has always helped in times of crisis. And this time, despite the temptation to give a steroidal push to non-farm sector demand, the government has focused on creating jobs, which is a more credible way to permanently raise incomes and, hence, purchasing power.

Sectoral impact

Agriculture: Focus continues on agriculture — Positive

Key budget proposals

- The target for agriculture and allied credit is set at Rs 10 trillion.
- Pradhan Mantri Fasal Bima Yojana, a key crop-insurance scheme, attracted an outlay of Rs 90 billion, compared with the FY17 revised estimate of Rs 132 billion.
- The allocation to Pradhan Mantri Krishi Sinchai Yojana is up 71% at Rs 34 billion, compared with the FY17 estimate. Also, the total corpus of NABARD's Long Term Irrigation Fund will be doubled to Rs 400 billion. A new micro-irrigation fund with a corpus of Rs 50 billion will be set up.
- A model law on contract farming will be prepared and circulated among the states for adoption. Additionally, states would be urged to denotify perishables from APMC.
- New mini labs will be established in all 648 Krishi Vigyan Kendras for soil testing.
- The coverage of National Agriculture Market (e-NAM) will be increased from 250 Agricultural Produce Market Committees (APMCs) to 585, with an assistance of Rs 7.5 million for each e-NAM.

Our view:

The Budget continued the government's focus on improving credit flow to farmers, irrigation facilities, soil testing, crop-insurance coverage, and selling and distribution of produce. The overall budgetary spending for the agriculture sector is up 5% to Rs 586 billion over the revised FY17 estimate.

The target for agriculture and allied credit is set at Rs 10 trillion, an increase of 5% over the estimated credit of FY17. In addition, spending on interest subvention is set at Rs 15 billion.

Coverage under the crop-insurance scheme is proposed to be increased from 30% of the crop area in FY17 to 40% FY18 and 50% in FY19. As of December 2016, the scheme covered 39 million hectare, accounting for 26% of the crop area. The scheme has led to only a 15% increase in the area covered under insurance, but has doubled the sum insured. The significant increase is mainly due to the removal of cap on the premium borne by the government.

In FY18, irrigation spending will rise 46% to Rs 87 billion from the FY17 revised estimate. The actual spending will be a key monitorable, given that the revised estimate is 12% below the FY17 budget estimate.

Proposals such as increasing e-NAMs, soil testing, contract farming, MNREGA, and setting up of dairy-processing fund would increase support for farm income.

Automobiles: Positive for tractors and two-wheelers, neutral for rest — Neutral

Key budget proposals:

- 24% increase in allocation to rural and allied sectors through higher agricultural credit, Mahatma Gandhi National Rural Employment Guarantee Act, and initiatives such as crop insurance scheme, national agriculture marketing, etc. The higher allocation also includes long-term irrigation projects as well as continued support to Pradhan Mantri Gram Sadak Yojna
- Personal income tax rate cut from 10% to 5% for Rs 0.25-0.5 million income bracket
- Railways to implement end-to-end integrated transport solutions for select commodities via partnership with logistics players
- Corporate tax for small enterprises (turnover <Rs 500 million) cut to 25%

Our view:

Measures to increase farm credit and other initiatives towards rural infrastructure development are expected to spur tractor demand in FY18. Expansion in crop insurance coverage and widening the reach of National Agriculture Market (e-NAM) will also indirectly boost demand, although its implementation will be a key monitorable. These rural initiatives, along with increase in disposable income following the lowering of income tax, will have a favourable impact on two-wheeler demand as well. However, the haulage segment of commercial vehicles will be slightly affected as the Railways over the medium/long term plans to enter the end-to-end transport solution business. Meanwhile, the benefit from corporate tax cut for small enterprises is expected to be minimal as only a small proportion of auto component suppliers are estimated to have a turnover of <Rs 500 million.

Cement: Infrastructure investments and affordable housing to drive demand — Positive

Key budget proposals:

- Pradhan Mantri Awas Yojana (PMAY) allocation increased by 39% to Rs 290 billion
- Allocation from Ministry of Rural Development increased by 10% to Rs 1.05 trillion in FY18
- Investments in cement intensive infrastructure segments (excl. power) up 9.8% to Rs 4.2 trillion. Total outlay towards national highways at Rs 1.24 trillion, up 11.1% over previous fiscal's revised estimates
- Affordable housing to be accorded infrastructure status

Our view:

Increased government spending on PMAY to provide impetus to housing segment, which has been fairly muted over the last few years. Further, grant of infrastructure status to affordable housing would facilitate easier access to low-cost finance and thereby support demand

A 9.1% increase in allocation to rural development and 44% rise in PMAY - Gramin likely to catalyse growth in cement demand from rural housing, which typically constitutes 35% of overall cement demand

Further, increased government spending on infrastructure, especially cement intensive sectors such as national highways (up by 11.1%), metros (15%), and other schemes (e.g., Swachh Bharat up by 27%), to augment cement sales

Financials: Focus on affordable housing, but inadequate capital support to banks — Neutral

Key budget proposals:

- Rs 100 billion capital support to public sector banks (PSBs) in FY18.
- Listing and trading of security receipts issued by a securitisation or reconstruction company under the SARFAESI Act in Sebi-registered stock exchanges to deal with banks' non-performing assets (NPAs).
- Infrastructure status to affordable housing to facilitate higher investments. Income tax exemption for developers of affordable housing with a carpet area of 30 and 60 square metres in the four metros and non-metros, respectively, instead of built-up area of 30 and 60 square metre.
- Banks' disbursement target doubled to Rs 2,440 billion for FY18 from Rs 1,220 billion for FY17 under the Pradhan Mantri Mudra Yojana.
- Refinancing of individual housing loans of up to Rs 200 billion in 2017-18 by National Housing Bank.
- Banks will be eligible for tax deduction of 8.5% (7.5% earlier) of total gross income to provide for bad and doubtful debts.
- Bills to curtail illicit deposit schemes and confiscate the assets of economic offenders.

Our view:

- Allocation of funds for capitalising PSBs seems inadequate given the high capital requirement to meet Basel-III commitments and continuous rise in gross NPAs. However, the listing and trading of security receipts issued by a securitisation or reconstruction company is a positive.
- Proposals for affordable housing will give a boost to real estate, allow promoters to raise funds at lower rates for longer tenure and avail of tax benefits, and create credit growth opportunities for the housing finance industry.
- Banks' RoA is expected to expand marginally because of proposed increase in the allowable provision for NPAs to 8.5%.
- Bills to curtail illicit deposit schemes and confiscate the assets of economic offenders will be a positive in the long term.

Infrastructure: Road and Railways are biggest beneficiaries — Positive

Total outlay (budgetary allocation + internal and extra budgetary resources or IEBR[4]) for infrastructure increased by 6% to Rs 5.1 trillion, with railways and roads being the biggest beneficiaries. Of this, Rs 2.9 trillion is on account of budgetary support.

Almost three-fourths of the incremental investment outlay (budgetary allocation + IEBR) focuses on two segments – roads and rail. Also, the increase of Rs 385 billion in the budgetary allocation towards various infrastructure segments was lower, compared with Rs 537 billion in the previous Budget. Of the Rs 385 billion, Rs 124 billion is towards roads, followed by Rs 93 billion for rural development, Rs 88 billion for Railways, and Rs 34 billion for power.

4 IEBR= Internal and Extra Budgetary Resources raised by public sector undertakings

(Rs billion)	Revised 2016-17			Budget 2017-18			Increase in outlay (% YoY)
Ministry	Budgetary support	IEBR	Total outlay	Budgetary support	IEBR	Total outlay	
Ministry of Urban Development	325	40	366	342	20	363	-1%
Ministry of Civil Aviation	35	25	59	27	33	60	0%
Ministry of Power	105	671	775	139	619	758	-2%
Ministry of New and Renewable Energy	44	123	167	55	82	137	-18%
Ministry of Railways	462	746	1,208	550	760	1,310	8%
Ministry of Shipping	15	44	59	18	48	66	12%
Ministry of Road Transport	524	593	1,117	649	593	1,242	11%
Ministry of Rural Development	961	-	961	1,054	-	1,054	10%
Ministry of Water Resources	48	82	129	69	90	159	23%
Total	**2,517**	**2,325**	**4,842**	**2,903**	**2,245**	**5,148**	**6%**

Source: Budget

Roads- Rise in budgetary allocation positive

Key budget proposals

- Budgetary support for national highways and the National Highways Authority of India (NHAI) has been increased by 24% and 59%, respectively, over the revised estimates of FY17
- Budgetary support to the rural road scheme, the Pradhan Mantri Gram Sadak Yojana, has been maintained at Rs 190 billion

Our view

- NHAI's share of road cess was lowered in FY17, making it more dependent on external borrowing. With the authority now executing more projects on cash contract/hybrid annuity basis, utilising public funds, a higher share of the cess will provide it with more secure funding.
- The target year for completion of the Pradhan Mantri Gram Sadak Yojana was brought forward by three years to 2019 in the previous Budget. The allocation was increased by 26% in FY17 to Rs 190 billion, and maintained in FY18 to support the revised target.

Railways: Investments rise, safety gets a push

Key budget proposals

- Investment outlay of Rs 1.31 trillion for FY18
- Budgetary allocation of Rs 550 billion for FY18
- New safety fund of Rs 1 trillion to be spent over a period of five years.
- Unmanned level crossings on broad-gauge lines to be eliminated by 2020
- At least 25 stations to be awarded via the public-private partnership route during FY18
- All coaches to be fitted with bio-toilets by 2019

Our view:

The increase in outlay is in line with our expectations, given that the budgeted outlay of Rs 1.21 trillion in FY17 is likely to be met. Budgetary support has been increased 19% to Rs 550 billion over the revised FY17 estimate. Further, with the merger of Railway Budget with the General Budget from FY18, the Railways have been exempted from payment of dividend. This will nearly double internal resources to Rs 200-230 billion annually. Though critical, safety-related projects have been typically funded from internal accrual, which has been a constraint historically. Thus, the newly introduced safety fund, Rashtriya Rail Sanraksha Kosh, is a positive step. However, the specific structure to source these funds is to be finalised. CRISIL Research expects rail safety investment to treble to ~Rs 900 billion over FY16-20 compared with FY11-15, with the bulk of spending on rail under- and over-bridges (which would eliminate unmanned level crossings) and track renewals. Listing of the Indian Railway Catering and Tourism Corporation Ltd, Indian Railway Finance Corporation Ltd, and Indian Railway Construction Company Ltd will unlock funds for the government. Focus on station redevelopment and passenger amenities such as bio-toilets also augur well. The proposal to introduce a metro rail policy is a positive, but further details are awaited.

Power: Higher budgetary allocations to boost investments in T&D and RE space

Key budget proposals

- **Budgetary allocation:** Outlay for rural electrification schemes has increased 35% to Rs 106 billion. For renewable energy, budgetary allocation has increased 26% to Rs 55 billion. Allocations under the modified special incentive package scheme and electronic development fund have risen to ~Rs 8 billion from Rs 0.5 billion. However, allocation to the Indian Renewable Energy Development Agency has been cut 34% on-year to Rs 80 billion.
- **Duties and levies:** Basic customs duty on liquefied natural gas to be reduced to 2.5% from 5%

Our view:

- Higher outlay toward rural electrification is expected to increase rural power demand and lower distribution losses. This, in turn, would benefit the power generation segment.
- Higher budgetary allocation for renewable energy will also facilitate higher capacity additions in the segment through higher disbursement under various viability gap funding schemes and other central financial assistance. However, no mention regarding extension of generation-based incentive (Rs 0.5/unit) beyond March 2017 is expected to impact wind power capacity additions adversely.
- In the Budget, there is no mention of extension of a 10-year tax holiday (under Section 80 I) available beyond March 31, 2017. This could adversely impact private sector projects (5-6 GW in power generation and 24 competitively bid inter-state transmission projects), which are expected to be commissioned by FY20. In the absence of this extension, equity internal rate of return would be lower if such projects have not considered this scenario in their competitive bids.
- The significant rise in allocation under M-SIPS scheme and EDF, which provides capital subsidy of up to 25%, is expected to benefit major domestic solar cell and module manufacturers, as well as foreign players planning to set up manufacturing base in India.

- While basic customs duty on liquefied natural gas has been reduced, it will not benefit the power sector as the duty is waived completely under the 'Scheme for Utilisation of Stranded Gas-based Generation Capacity'. However, continuation of the scheme beyond March 31, 2017, would be a key monitorable.

Airports and ports: No new project announcements

Outlay, including IEBR for civil aviation, remained largely flat at Rs 60 billion. However, allocation declined 22% to Rs 27 billion compared with the revised FY17 estimate owing to reduced equity support to Air India. Outlay (including IEBR) for shipping, including ports, increased 12% to Rs 66 billion, with the Sagarmala project getting a boost.

Metals: Infrastructure investments and affordable housing to aid demand — Positive

Key budget proposals

- 10.4% higher allocation for infrastructure sector
- 10 million affordable houses by 2019; ~39% rise in allocation for Pradhan Mantri Awas Yojana
- Investment in rural electrification through Deen Dayal Upadhyaya Gram Jyoti Yojna to jump 44% on-year to Rs 48 billion in FY18.
- Import duty on nickel (key input for stainless steel) waived.
- Lower basic customs duty (BCD) on inputs for value-added steel products
- 30% export duty on previously exempted 'other aluminium ores and concentrates,' and 15% on 'other aluminium ores, including laterite'.

Our view:

- Higher allocation for infrastructure, which comprises 27-30% of steel consumption, and higher investments in Railways, Metro projects, etc., to fuel demand.
- Affordable housing target to provide impetus to an otherwise low-key long steel segment.
- Higher budget allocation for rural electrification to boost demand for aluminium cables and conductors, which comprise 56% of primary aluminium consumption.
- Zero customs duty on nickel to lower per tonne procurement cost by 2-3% for stainless steel makers, as nickel is largely imported.
- Concession on/exemption of BCD on inputs (magnesium coated CR coils for steel products such as CRGO, stainless steel tape, HR coils specific to tubes and pipes, etc.) to marginally lower cost for value added steel products, that anyway account for a miniscule share in overall steel demand.
- Imposition of export duties on 'other aluminium ores and concentrates' and 'other aluminium ores, including laterite' to slow down the unprecedented surge in export volumes and conserve domestic resources. Exports surged from one kilo tonne (KT) in FY14 to 158 KT in FY16, and further to 177 KT in first half of FY17.

Oil & Gas: Reduction in basic customs duty on LNG — Positive

Key budget proposals

- Reduction in basic customs duty on liquefied natural gas (LNG) from 5% to 2.5%
- Creation of an integrated PSU oil major
- Increase in strategic reserves to 15.33 MT from 5 MT by installing new caverns to store crude oil at Odisha and Rajasthan

Our view:

- Reduction in basic customs duty on LNG will lower the landed price of gas by ~ 2%. This will marginally enhance competitiveness of gas in the industrial sector, compared with liquid fuels such as furnace oil. No material impact is expected on other major gas consuming sectors such as power, fertilisers and compressed natural gas (CNG). While LNG imports by the power sector already attracts nil custom duty, fertiliser manufacturers are reimbursed by the government for gas costs. The auto CNG segment does not consume LNG, given assured domestic gas supply.
- Creation of an integrated PSU oil major is expected to provide greater flexibility for investments and acquisitions, and potentially provide cost synergies.
- Current strategic reserves are adequate to maintain an inventory of 10 days. An increase in strategic reserves to 15.33 MT will enhance inventory carrying capacity of oil to over 20 days, thus ensuring energy security.

Real Estate: Continued focus on affordable housing by the government — Positive

Key budget proposals

- Affordable housing receives infrastructure status.
- Allocation to Pradhan Mantri Awas Yojana (PMAY) increased from Rs 200 billion to Rs 290 billion
- Allocation of Rs 200 billion to National Housing Bank for refinancing individual loans
- Under the scheme for profit-linked income tax deduction for promotion of affordable housing, instead of built-up area, carpet area will be considered – 30 sq m limit will apply to housing within municipal limits of four metropolitan cities, and 60 sq m to rest of the country. The period for completing an affordable housing project under the scheme has also been increased from three to five years.
- For developers for whom constructed buildings are stock-in-trade, tax on notional rental income will only apply after one year, from the end of the year in which completion certificate is received.
- Holding period for immovable assets reduced from three to two years; for long-term capital gains, indexation year changed from 1981 to 2001
- For joint development agreements (JDA) signed for property development, liability to pay capital gains tax will arise in the year the project is completed.
- Persons holding land on June 2, 2014, the date on which the state of Andhra Pradesh was reorganised, and whose land is being pooled for creation of capital city of Andhra Pradesh by the state government, will be exempted from capital gains tax.

- Restriction to set off loss from house property against income under any other head during the current year set at Rs 0.2 million. A loss, not so adjusted, would be allowed to be carried forward to offset house property income for eight assessment years.

Our view:

- Impact of demonetisation was perhaps felt most strongly in real estate sector. In what could be construed as a bid to boost the sector, Budget announcements for the sector were largely positive.
- A long-pending wish of the real estate industry was partially realised with affordable housing sector being granted 'infrastructure' status. This entails lower finance costs. Grant of infrastructure status, coupled with priority sector status accorded to retails loans for affordable housing projects by RBI in July 2014, ensures adequate demand and supply-side impetus to the sector. Typically, sectors enjoying infrastructure status can also avail of loans under ECB route. However, this facility was already granted to affordable housing sector in 2014 by RBI.
- The finance minister increased allocation under PMAY Grameen from Rs 150 billion to Rs 230 billion, and committed to build 10 million houses by 2019. Allocations under PMAY Urban were also raised marginally from Rs 50 billion to Rs 60 billion, in line with the government's broader vision of 'Housing for All by 2022'.
- Amendments in 'area' definition for affordable housing and extension of completion timeline for availing of tax exemption, will further widen the scope of affordable housing.
- Given that inventory of completed units with occupation certificates is much lower than inventory of under-construction units, relaxation of tax on notional rental income for one year will impact real estate developers marginally.
- Deferment of payment of capital gains tax in case of JDAs is expected to benefit land-owners and may become the preferred model of development.
- Announcement on restriction on set-off of loss from house property against income under any other head, is expected to affect investor demand marginally.

SMEs get a boost with a cut in the tax rate — Neutral

Key budget proposals

- Allocation to the MSME (micro, small and medium enterprises) segment increased to Rs 65 billion for FY18. In FY17, it was revised up from Rs 34.7 billion to Rs 54.7 billion.
- Tax rate for MSMEs with a turnover of less than Rs 500 million in FY16 has been cut from 30% to 25%.
- SIDBI to refinance credit institutions that give unsecured loans to SMEs.
- Special schemes for creating employment in leather and footwear industries to be unveiled; however, more details are awaited.
- Vocational courses for skill development to be provided at a cost of Rs 22 billion.
- The basic customs duty for the following commodities reduced:
  - Finished leather – from 7.5% to 2.5%

  - Capital goods (such as ball screws, linear motion guides and CNC systems, which are used in the manufacturing of CNC machine tools). It is reduced from 10% (CNC systems) and 7.5% (ball screws and linear motion guides) to 2.5%.
- Basic customs duty for the following commodities increased:
  - Cashew nuts (roasted, salted or roasted and salted) – from 30% to 45%
- Excise duty for the following commodities increased:
  - Cigarettes, related products and substitutes – from Rs 3,755 per thousand to Rs 4,006 per thousand
- Additional duty for the following commodities increased:
  - Pan masala – from 6% to 9%
  - Chewing tobacco – from 6% to 12%

Our view:

- The increase in allocation should promote growth and development of the MSME sector.
- The reduction in the tax rate for MSMEs will directly impact 96% of MSMEs, thereby improving their cash flows; however, the extent of impact will vary depending on the bargaining power with customers.
- Availability of skilled workers has always been a pain point for MSMEs. The schemes announced in the Budget will provide MSMEs with skilled employees, leading to better productivity.
- The reduction in import duties for certain capital goods will help the machine tools industry's cost management.
- The increase in the excise duty on chewing tobacco and cigarettes would adversely impact the tobacco processing industry.

Textiles: No major changes in budget — Neutral

Key budget proposals

- Tax rate for SMEs (of annual turnover up to Rs 500 million in 2015-16) reduced to 25% from 30%
- Allocation to textile sector remains relatively unchanged,~Rs 62.3 billion in 2017-18 from Rs 62.9 billion in 2016-17; lesser allocation for both Amended Technology Upgradation Fund Scheme (ATUFS) and cotton procurement is offset by higher allocation for the Textile Package announced on June 22, 2016.

Our view:

- With a significant proportion of textile sector (>60% unorganised) in the SME segment, reduction in tax rate to improve bottom line of companies
- Lower allocation to ATUFS to limit capital investment in textiles
- Sharp reduction in allocation to price support scheme (Rs 0.1 million in 2017-18 as against Rs 6.1 billion in 2016-17) under the Cotton Corporation of India, may lead to greater volatility in cotton prices in next fiscal.

- Increase in allocation to Textile Package provisions, mainly Employee Provident Fund Scheme reforms and enhanced duty drawback coverage, will marginally boost readymade garment (RMG) exports. However, more efforts are needed to enhance market access and encourage production of man-made fibre-based garments, to give RMG exports a bigger push.

Technology, Media and Telecom: Long-term benefit from budget's digital focus and local sourcing — Neutral

Key budget proposals

- Budgetary allocation of Rs 100 billion for Bharat Net for FY18, as opposed to Rs 60 billion for the current fiscal
- Special additional duty of 2% for populated printed circuit boards (PCBs) used in mobile phones and computer hardware. Allocation for hardware manufacturing promotion increased to Rs 7.45 billion
- Digitisation of rural records by NABARD
- Launch of DigiGaon scheme with focus on providing tele-medicine, education through digital technology in rural areas
- Promotion of cashless transactions

Our view:

- Increased expenditure on Bharat Net and focus on cashless transactions will promote data services and increase usage of internet.
- Costs of locally manufactured mobile phones can increase by up to 1% given that import duty on PCBs has risen (PCBs account for 25-30% of the production cost). This could lead to setting up of PCB units in India.
- Government's revenue from telecom sector (spectrum payments, service tax, spectrum usage charges and licence fees) for FY17 has been revised downwards to Rs 787 billion as against Rs 990 billion estimated in Budget 2016-17. Of this, spectrum payments would account for Rs 430 billion. For FY18, government receipts from the sector have been estimated at Rs 443 billion.
- Opportunities in domestic IT services market, which contribute to around 10% revenue for large IT players, will increase with digitisation, promotion of a cashless economy, and improvement of IT infrastructure in rural areas.

Financial Markets

Debt market – To benefit from fiscal prudence and extension of exemptions for FPIs

The debt market has much to cheer from this budget. The government's net market borrowing has been restricted to Rs 3.48 trillion after buyback in 2017-18 against Rs 4.25 trillion in the previous year. Lower government borrowing could ease yields and create more appetite for institutional investors to invest in corporate bonds.

The government will notify additional bonds that are eligible under Section 54 EC. This will make way for more issuers to raise funds from such bonds, bring down their borrowing cost and offer more choice to investors.

The government has also extended the eligible period of concessional tax rate on interest in case of external commercial borrowing and extension of benefit to rupee-denominated bonds with respect to borrowings made before July 1, 2020. Similar extension has been provided to foreign institutional investors (FIIs) and qualified foreign investors (QFIs) on their investments in government securities and rupee-denominated corporate bonds. The extension of concessional withholding tax is not expected to have much impact on yields, but gives clarity on taxation liability.

Exemption on capital gains for investors of rupee-denominated bonds (masala bonds) on account of two cases – 1) sale from non-resident to another non-resident and 2) rupee appreciation at the time of redemption – will encourage non-residents to invest in these bonds and improve liquidity.

Equity Market - Time for earnings recovery

From the equity market's perspective, the budget strikes the right balance between fiscal consolidation and spending. Gradual waning of the demonetisation impact, increased spending on rural, agriculture and infrastructure sectors are a good augury, and should mark the beginning of recovery in earnings (also aided by a low base). Another positive is maintaining status quo on long-term capital gains tax on equity and the definition of 'long-term'. Supportive domestic factors notwithstanding, uncertainties with respect to the new US administration's policy stance, sluggish global economic growth and headwinds (such as rise in crude oil and commodity prices) will have a bearing on next year's performance.

Belying expectations of a populist budget, the finance minister remained on the path of fiscal consolidation, setting a fiscal deficit target of 3.2% in FY18 and 3% in FY19, which has been welcomed by the market. The budget pegs the gross market borrowing at Rs 6 trillion, a decline over the previous year. This fiscal arithmetic appears credible given a budgeted 8% increase in indirect tax receipts and reasonable estimates of direct tax collections on the back of potential increase in the tax base after demonetisation. We view continued fiscal prudence as a long-term positive for the Indian equity market.

The budget also aims at providing the much needed stimulus to the struggling rural economy through a slew of initiatives such as higher allocation to MNREGA, expanding agricultural credit to underserved areas and increased coverage under Fasal Bima Yojana.

We believe it will take one-two quarters before rural- and infrastructure-focused measures along with income tax incentives start providing impetus to consumption spending. In such a scenario, the risk-reward ratio continues to favour retail focused banks/NBFCs, FMCG, and sectors such as consumer durables, automobile, cement and agriculture, which are well placed for an earnings uptrend.

The external environment, however, could provide some roadblocks for domestic equities. Foreign institutional investors, which pumped in $6 billion in H1FY17 have pulled out $4.3 billion in the past four months on account of demonetisation and increase in global yields. With uncertainty regarding policy actions by the new US administration and sluggish global growth, adverse impact on earnings of export-oriented sectors such as IT services, pharmaceuticals and textiles could impede growth.

Nifty consensus earnings per share is estimated to grow 20%+ in FY18 -- it is an optimistic estimate in the backdrop of a possible spillover effect of demonetisation, rising commodity prices (which would keep margins under check) and uncertainty regarding US policies. Accordingly, we expect earnings growth to be a bit lower than consensus. The implied P/E multiple on FY18 earnings is ~18x, which is higher than the long-term median of 16x. We believe this is justified because of declining cost of capital (owing to fiscal prudence) and expected recovery in earnings growth.

Mutual funds – Making the industry leaner

The last couple of years have seen changes in tax laws to improve tax neutrality for investors from merger or consolidation of schemes as well as plans within the scheme. This year, the provision has specifically been extended to provide the cost of acquisition from the period for which units in a consolidating plan of mutual funds were held by the assessee. The Securities and Exchange Board of India has been pushing for standardisation and consolidation of schemes in the industry, and this provides clarity.

Meanwhile, considering the lackluster participation in Rajiv Gandhi Equity Savings Scheme (RGESS) since its launch in 2012, the government has decided to phase out tax sops under Section 80CCG from the assessment year 2018-19. RGESS was launched to promote capital market investment and allowed tax savings up to a maximum of Rs 25,000 for first-time investors in the securities market with annual gross total income of Rs 1.2 million. The move will not substantially impact the mutual fund industry considering the marginal size of the category at 0.09% of total industry assets. While the overall intent was to enhance participation in the capital market, we will now have to wait and watch for new initiatives.

CPSE ETF – Win-win for the government and investors

Seeing the success of the divestment route through central public sector enterprises (CPSE) exchange traded funds (ETFs), the government plans to launch a new ETF with diversified CPSE stocks and other government holdings. To bring in more stocks under the ambit, the government plans to list railway public sector enterprises such as IRCTC, IRFC and IRCON on stock exchanges and plans to create an integrated public sector 'oil major'. The move is a win-win for the government (an avenue for divestment gains) and investors (investment opportunity).

Small measures for pension subscribers

To bring parity between retirement funds in the country, the previous budget had provided tax exemption of 40% of the pension wealth received by an employee from a product. In order to provide further relief to an employee subscriber of the National Pension System (NPS), additional exemption for partial withdrawal up to 25% has been provided in this budget, thus improving liquidity of the product. Further, to bring parity between salaried and non-salaried individuals, the total deduction for investment in NPS has been increased to 20% for the self-employed similar to the salaried class (10% self, 10% by employer). This is a positive step for NPS, which was originally introduced with the objective of expanding pension coverage within the unorganised sector.

The government also proposes to launch an 8% per annum interest income assured plan for 10 years from LIC for senior citizens -- an added opportunity to manage cash flow in the sunset years. Given the declining interest rate scenario, finer details of the scheme are awaited.

Other measures

The government proposes to introduce a bill to curtail the menace of illicit deposit schemes operated by unscrupulous entities who exploit the regulatory gaps in the Multi State Cooperative Societies Act, 2002. The intent is to protect poor and gullible investors. This move could bring more individuals into the mainstream financial system, to mutual benefit.

Infrastructure status to affordable housing will enable projects to get associated benefits such as lower cost for developers. It will also attract new investors such as infrastructure investment trusts, insurance companies, infrastructure debt funds and banks.

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