

It will be the first budget in Modi 2.0 era and hence hopes are high for a path-breaking Budget. The NDA II has come back with a huge mandate. This has fuelled expectations of bold reforms/measures that can have a positive long term benefit on the economy, initial effect of which should be visible soon.

The forthcoming Union Budget (the first by Mrs Nirmala Sitharaman) is awaited keenly in the background of slowdown in the economy and liquidity squeeze faced by most businesses. Overall activity from eight high-frequency indicators show the economy lacks momentum. Gross domestic product growth has slowed to a five-year low of 5.8% (nominal growth 9.4% - a 13 quarter low) in the first quarter of 2019. Even the Global IIP is slowing and is near decadal lows. It will be prudent to lift government spending that can offset private sector slowdown. This being the first Budget of Modi 2.0 will also lay down broad guideline on the thought process of the Govt after winning a large majority. In FY20 budget, we expect the government to fund its election promises and maintain policy continuity (focus on agriculture, rural development, infra spending). Providing sources of funds to MSME could also gain attention in the Budget.

The list of what the FM should do can go long and such a wishful list has little meaning if these wishes are made in isolation without considering their impact on the overall economy. Instead one should focus on what one thinks the FM may do under the prevailing circumstances. We do not expect material changes on tax front. Among indirect taxes GST is the prerogative of the GST council and hence apart from some policy direction, no changes in GST are expected out of the Budget. Some tinkering of import/export duty is possible. The underlying focus on Antyodaya – benefit the weakest sections of the society could mean that the sops that most urban HNI and MNI seek or expect may not fructify. These two categories will directly and indirectly benefit only when the economy gains momentum.

Steps that would be welcome by the Capital markets

1. Cut in LTCG/Abandoning LTCG - less likely. The finance ministry however is considering extending the holding period for short-term capital gains (STCG) tax on listed securities from one year to three years, bringing equities on a par with some other asset classes in tax treatment. This proposal could be negative for markets as the period of holding of shares to qualify for Long term capital gains would be 3 years vs the current 1 year.
2. Rationalise Dividend Distribution tax – less likely
3. Raise exemption limit for income tax from Rs.2.5 lakhs to Rs.3 lakhs – likely. This tax move would put at least Rs 2,500 more in the hands of each of India's 50 million taxpayers boosting their spending power.
4. Cut tax rates for corporates – We think corporates with sales of Rs.500 cr (vs the current Rs 250 cr) will be taxed @25% vs normal 30%. According to the Income Tax department, about 100 firms comprising 0.012 per cent of the 8,00,000 companies contribute more than 40 per cent corporate tax collection. The government is not in a position to extend the corporate rate cut to such critical taxpayers.
5. Sticking to 3.4% fiscal deficit target without any jugglery or aggressive tax collection, telecom revenue or divestment targets. – less likely. Despite tax collection targets for FY20 seeming aggressive (Direct tax growth 22.6%, Indirect tax growth 24.9%) based on actual FY19 numbers and sluggish Q1, we expect government to maintain the optimism on tax collections to showcase a manageable fiscal target. The FM may tweak the targets downward a bit and manage the fiscal deficit by

lowering capital expenditure in Q4FY20. The six-member committee on the economic capital framework for RBI is likely to submit its report by the end of July 2019. This committee is expected to identify 0.5-1.5% of the gross domestic product (GDP) as excess RBI capital, depending on the methodology. Using this windfall for specific tasks like bank recapitalization will help the economy by allowing the government to concentrate on other avenues like infra spending. Ideally this money should be used to bring down the debt of the Govt or partly to recapitalize PSU Banks after thorough study. Reflation demands and increasing of fiscal deficit by 50 bps seems very aggressive and less likely. We may end up somewhere in between.

6. Announcing a pathway to cut interest rates on small savings schemes. – likely. A 10 bps cut in small savings rates has been announced on June 28. However the cut may not be large given the dependence on them to fund off balance sheet items by the Govt. Savers however will be disincentivised at a time when the savings rate of households has fallen from 23.6% in FY12 to 17.2% in FY18.
7. Announcing strategic sale of PSUs – less likely going by the way divestment targets over the past few years have been met by selling stake in one PSU to another PSU or to an ETF. Also floating the idea of launching financial sector ETF also denotes the same intent.
8. Infusing more capital into the public sector banks, removing the roadblocks for the speedy resolution of IBC cases and incentivising banks to buy good quality NBFC assets may ease the financial sector woes. – likely. However the government spent Rs.2.06 trillion in recapitalizing public sector banks (PSBs) over the last two fiscal years. This has so far not had the desired effect on strengthening the lending capacity of PSU Banks.
9. Widening the tax base - likely because due to a smaller revenue base, India's debt-revenue ratio is much higher than that of many other 'BBB' rated economies. In FY18, the country's debt-revenue was 3.3x compared with the Fitch-rated 'BBB' country's median value of 1.7x.
10. Allow issue of Tax Free bonds by PSUs to fund infra spend – likely. However the cumulative debt of the National Highway Authority of India (NHAI) has mounted to Rs 1.78 lakh crore in FY19 from around Rs 40,000 crore in FY14. The borrowing is expected to go up to Rs 3.31 lakh crore by FY23, as its needs resources to fund construction of around 25,000 km highway projects in six years under the Bharatmala programme starting from 2017-18. Food Corporation of India borrowing was of more than Rs.1.21 lakh crore from NSSF just in FY18. Over the last few years spending on Infra and rural has risen at the cost of social sector and defence. All these will lead to higher off balance sheet funding. If we include food, fertiliser, fuel, roads, irrigation, railways, power etc, the borrowings by Govt entities have risen YoY over the past 3-4 years and the Govt has managed to show a rosy picture of fiscal consolidation. This has to be set right in some way. Also Infra spending has to be scrutinized carefully before committing the spend as recent experience shows that this does not generate self-sustaining rise in incomes/activity by itself and demands fresh doses of spend every now and then. Instead diverting part of this spending on education and healthcare may have more lasting benefits. Having achieved access and equity in school education, emphasis should now be on quality of learning and employability. India spends only <4% of GDP on healthcare vis-a-vis world average of > 9%
11. Liberalisation of FDI norms to attract investments in labor intensive industries to promote employment. Provide sops in Income Tax/ Corporate Tax for fresh recruitment subject to conditions - likely.
12. Include Fuels in GST – less likely. Given the current precarious fiscal condition, this proposal will have to wait.
13. The AT&C (Aggregate Technical & Commercial) losses, although reducing over the years, have remained unchanged in FY19. The current levels are still higher than the policy target. This has proved to be the tough issue in power sector reforms. Some policy measure to induce faster reduction of these losses is likely.
14. Besides a few shortcomings, the investment tool- REIT is an asset for the whole real estate market of India. The Government may make some positive announcements in this segment too.
15. Interlinking of rivers to get more thrust – likely. Also provision of drinking water for all households could be one of the key objective under the Budget. This could benefit a host of companies operating in the water recycling/management and contractors involved in water pipe laying apart from steel and plastic pipe manufactures. However the proposed funding of this project will be keenly watched.

Steps that would not be welcome by the Capital markets

1. Fresh levy of Farm cess of 2% on Income Tax / Corporate tax to fund relief to farmers
2. Excise duty on Petrol/Diesel that was cut by Rs.1.50 in Oct 2018 may be raised again – likely – but given the current soft crude prices, the impact of this may not be very negative.
3. A reinstatement of a Cash Withdrawal Tax (CWT), though with different terms and conditions, is likely. This time the CWT would be likely levied if the total cash withdrawn from the bank is more than Rs 10 lakhs in a financial year. The motive behind CWT could be to promote digital transactions and also to curb the circulation of black money which the current government is keen on.
4. Any increase in Income tax on Life Insurance companies from the present 12.5%+SC+cess
5. Any income tax levy on ULIP maturity proceeds received from life insurance companies.

We expect the trend of a diminishing budget impact on the market to continue. Since 2010, the Sensex has gone up seven times out of ten in the month after the budget (including the interim ones). But then, the benchmark index has also fallen eight out of ten times during the month prior to the budget. This time as we have not seen a significant correction ahead of the budget, chances of a big rise post budget seem limited.

GST collection growth, rural income growth and Insolvency code progress are three major themes to follow in 2019-20. Private consumption is expected to stay strong; 2019 monsoon could be a concern. Overall, we see fewer negatives from this budget. Possibilities of an unexpected large positive is also limited.

The US Fed has taken a decisively dovish turn and is now on the cusp of a rate easing. This implies leeway for domestic fiscal/monetary authorities across EMs to rejig/tweak macroeconomic policies to their respective domestic business cycle realities without worrying about external vulnerabilities such as capital outflows or rising rates.

FM Nirmala Sitharaman has the unenviable task of balancing growth with prudence. Though there is a clamour for fiscal expansion given the current trying circumstances (like in FY02 and FY09), reflation need to be done in a measured way and reforms have to be taken forward. Whether the current conditions require leeway on fiscal targets (and if yes, to what extent) is debatable. Going by the past track record, this Govt may not take too much leeway on this aspect. Given the rising populism across the globe, it would be prudent not to pander to short term needs in a way that the medium term structure of the economy is damaged.

Markets could react initially positively to the Budget as a crucial event (that could potentially turn out to be negative) is out of the way. Sectoral and stockwise reactions could continue for a couple of days. PSU stocks could perform even beyond that if the measures announced are prudent, credible and achievable. After 1-2 weeks, the markets could come back to its original trajectory reacting to the global risk appetite, interest rate trends, local micro and macro developments.

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HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Binkle R. Oza Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

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