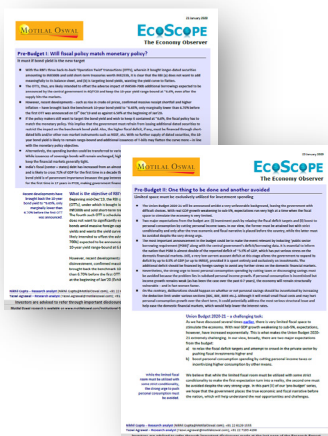
MOTILAL OSWAL

EcoScope
The Economy Observer

Pre-Budget III: Why will 2020-21 be more challenging year?

Weak RBI support could entirely offset better tax growth

- **In this third and final report of our pre-budget series, we discuss the factors that make the Union Budget 2020-21 very challenging. In FY20, while net taxes are likely to grow only ~3% (v/s budgeted growth of 25.3%) and divestment proceeds will also be likely only 50-60% of the target (down 30% from FY19), total receipts are still expected to grow 6% YoY, primarily helped by unexpectedly large dividends from the RBI amounting to INR1.48t. Besides, the cumulative rate cuts of 135bp in CY19 will help the government save ~INR600b on its interest payments. Together, thus, the RBI provided a massive support of INR2.1t (or 1.03% of GDP) in FY20, which went almost unappreciated.**
- **Things, however, will be different in FY21. Even if we assume disinvestment proceeds of INR1t and higher growth of ~10% in (net) tax receipts, the absence of the RBI's support can turn out to be an offsetting factor. With (a) the banks parking excess funds (averaging INR1.9t till 24th Jan'20) at the RBI's liquidity adjustment facility (LAF) window v/s average LAF deficit of INR459b last year and (b) no room for further rate cuts, the government is unlikely to receive as large a support in FY21. Also, if the RBI provides an interim dividend this year, the surplus next year will be even lower.**
- **Overall, notwithstanding expectations of better GDP growth next year, total receipts could grow slowly at only ~4% YoY in FY21 vis-à-vis expected growth of 6% this year. Assuming an unchanged fiscal deficit of 3.5% of GDP, spending growth would also be lower at 6.6% next year, as against ~7% this year. The budgeted estimates (BEs) to be presented in the budget on 1st Feb'20, however, could be very different from these estimates.**



In Part I of our pre-budget note series, we had highlighted the need for a fiscal policy to match the monetary policy and discussed about the limited fiscal space available in Part II. In this third and final note, we argue that, notwithstanding higher expectations, the Union Budget 2020-21 could be even more challenging.

RBI's exceptional support in otherwise dismal year

Total receipts of the government increased at a respectable ~13% YoY in the 8MFY20 (Apr-Nov'19) – much better than 3.4% growth in the year-ago period but short of 25% growth budgeted in the Union Budget 2019-20 presented in Jul'19.

Taxes accounted for only ~16% of total receipt growth, while non-tax revenue receipts accounted for more than four fifths of total receipt growth in 8MFY20.

Details of total receipts, however, reveal a very interesting insight. While (net) tax receipts increased at a dismal 2.6% over Apr-Nov'19 (vis-à-vis 4.6% growth in the same period last year), large part of reasonable growth in total receipts is attributed to non-tax revenue receipts, which increased ~68% YoY, following 31% YoY growth in the corresponding period last year *(Exhibit 1 on the next page)*. It implies that taxes (which account for ~80% of total receipts) accounted for only ~16% of total receipts growth (2.1 percentage point (pp) out of ~13% growth), while non-tax revenue receipts (NTRR) accounted for more than four fifths of total receipts growth (10.5pp out of ~13% growth) in 8MFY20 *(Exhibit 2)*. Disinvestments, albeit 10% higher than in the year-ago period, accounted for only ~2% of total receipts growth in 8MFY20.

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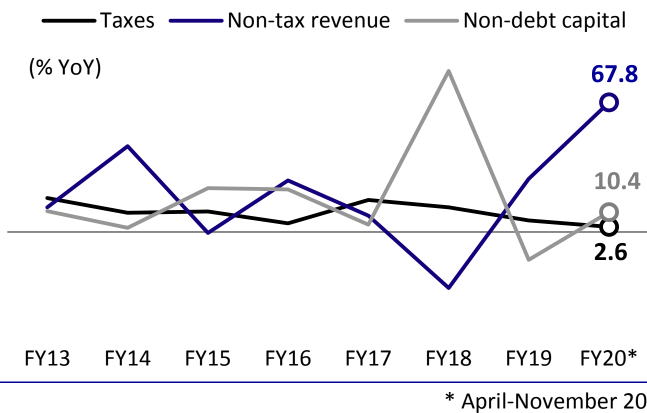
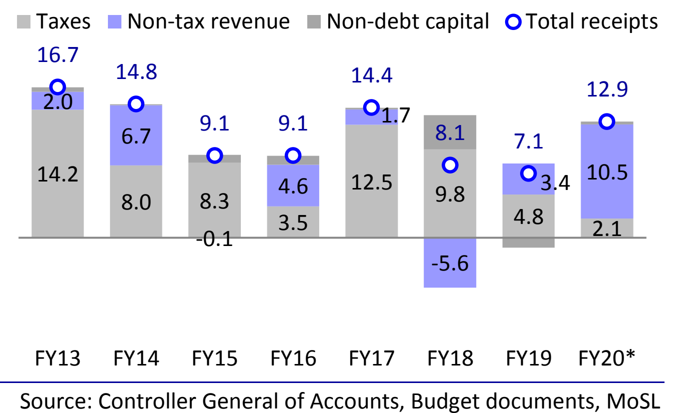
Exhibit 1: Non-tax revenue receipts grew ~68% YoY over Apr-Nov'19…



* April-November 2019

Exhibit 2: …and accounted for more than four fifths of total receipts growth in FY20*

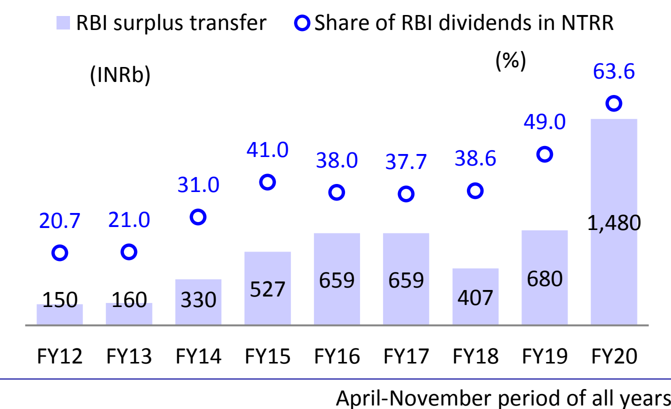


Source: Controller General of Accounts, Budget documents, MoSL

Exceptional RBI dividend of INR1.48t accounted for about two thirds of total NTRR this year, much higher than ~50% in FY19 and ~40% in the previous years.

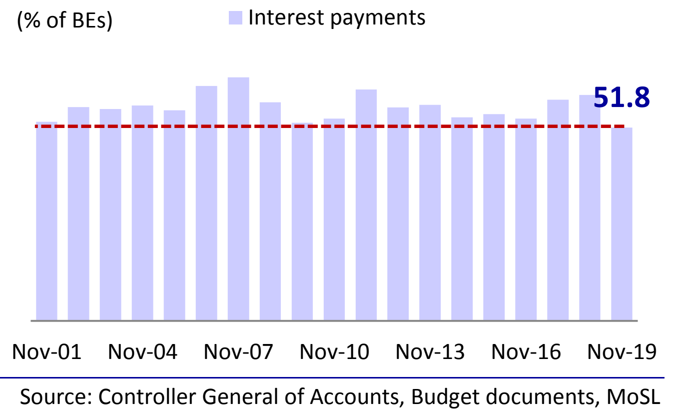
A large part of these NTRR has been the exceptional amount of RBI surpluses transferred to the central government, amounting to as much as INR1.48t (adjusting for the interim dividend of INR280b paid in Feb'19). Not only the amount was more than double of the transfers made in any previous year, but also it accounted for as much as about two thirds of total NTRR this year, much higher than ~50% in FY19 and ~40% in the previous years *(Exhibit 3)*.

Exhibit 3: RBI surplus transfer has been an exceptional support to government this year…



April-November period of all years

Exhibit 4: …and lower interest rates could also lead to large fiscal savings of ~INR600b



Source: Controller General of Accounts, Budget documents, MoSL

Overall, the RBI provided massive support amounting to INR2.1t (or 1.03% of GDP) this year, as against INR0.9t budgeted in Jul'19.

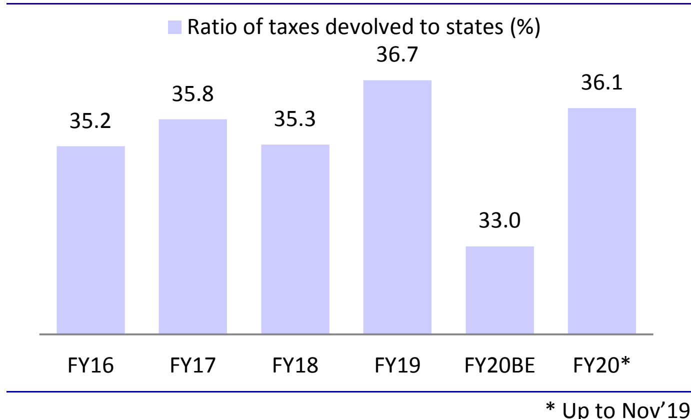
Massive surplus transfer was not the only way the RBI supported government finances this year. As the RBI has cut policy interest rates by a cumulative of 135 basis points (bp) in 2019, the benchmark bond yield has fallen from ~7.5% in Mar'19 to 6.6% now, helping the government to save on its interest payments. Not surprisingly then, interest payments by the government up to Nov'19 were only ~52% of BEs, the lowest in the past two decades and versus 60.5% in the corresponding period last year *(Exhibit 4)*. Based on the previous years' data, we believe that the government could save ~INR600b on its interest payments this year.

Overall, it implies that the RBI provided massive support amounting to INR2.1t (or 1.03% of GDP) this year, as against INR0.9t budgeted in Jul'19. Amid very weak tax receipts and shortfall in disinvestments, the RBI's support helped headline growth (of 12.9%) appear much better than otherwise.

Better tax growth unlikely to make up for absence of RBI's exceptional support in FY21

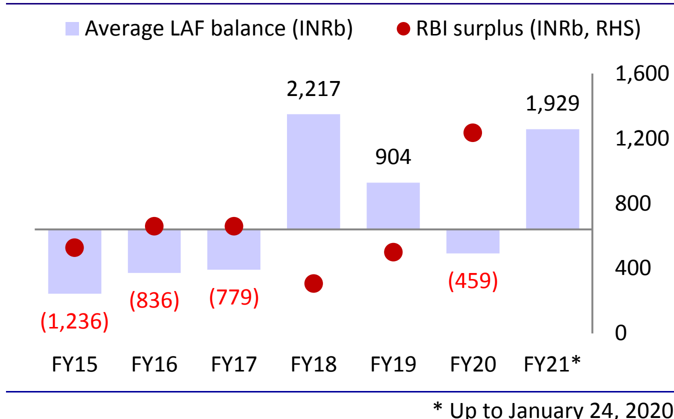
Of late, it is broadly believed that the worst is behind. According to the Bloomberg's January survey, real GDP growth is expected to pick up from 5% in FY20 to 5.9% next year, but the benchmark bond yield is likely to remain ~6.6%. Assuming a sharp improvement in tax buoyancy from 0.14x in FY20 to 1.08x in FY21, net tax receipts could increase 10% YoY next year, as against expected growth of ~3% this year. This is assuming that 35.5% of central taxes are devolved to the states, much higher than unrealistic assumption of 33% in the Jul'19 Union Budget and similar to the devolution rate in the previous years *(Exhibit 5)*.

Exhibit 5: Devolution of taxes to states was also under-estimated this year…



* Up to Nov'19

Exhibit 6: …and massive surplus on LAF window will limit RBI gains next year



* Up to January 24, 2020

Source: RBI, CGA, Budget documents, MoSL

Disinvestment target could be set much higher at INR1.0t, if not more, in FY21, as against expected realization of INR600b this year.

Further, although the government has failed to divest BPCL this year, it will certainly be budgeted for next year, implying that the disinvestment target could be set much higher at INR1.0t, if not more, in FY21, as against the expected realization of INR600b this year.

Notwithstanding much higher growth in taxes and non-debt capital receipts, the RBI will be unable to support government finances in FY21 as much as it has done this year for three different reasons:

As against an average LAF deficit of INR459b last year (Jul'18-Jun'19) on which the RBI earned and paid to the government, there was an average surplus of INR1.9t so far (Jul'19 – Jan'20) under the LAF window.

- In sharp contrast to FY20, as against an average LAF deficit of INR459b last year (Jul'18-Jun'19) on which the RBI earned (at repo rate) and paid to the government, there was an average surplus of INR1.9t so far (Jul'19-Jan'20) under the LAF window *(please note the inverse relationship in Exhibit 6 above)*. It implies that the RBI has paid to the banks this year, and thus, the surplus transfer to the government will be lower to that extent.
- Due to massive receipts crunch this year, it is largely believed that the central bank could decide to provide another interim dividend of INR300b or so to the government before end-Mar'20. While it will help this year, it also implies lower transfer next year.
- Since we **believe** that there will be no more rate cuts in CY20, the government is unlikely to save unexpectedly next year on its interest payments.

Against these limitations, India has added significantly to its foreign exchange reserves this year – by ~USD32b since Jun'19. However, the gains on this account are unlikely to be massive because the INR has been broadly stable this year.

Overall, even if we assume that the RBI will make another surplus of INR1.0t next year, it will transfer ~INR700b, after adjusting for the expected interim dividend of INR300b this year. Since dividends from other PSUs (excluding RBI) have been very stable at ~INR500b during the past five years, there could be a massive shortfall of ~INR1.0t in the government's NTRR, which will offset large part of higher growth in taxes and disinvestments.

Total receipts could grow slowly at only ~4% YoY in FY21 vis-à-vis growth of 6% this year.

Therefore, notwithstanding expectations of better GDP growth next year, total receipts could grow slowly at only ~4% YoY in FY21 vis-à-vis growth of 6% this year *(Exhibit 7)*. Assuming an unchanged fiscal deficit of 3.5% of GDP, spending growth would also be slightly lower at 6.6% next year, as against ~7% this year. The BEs to be presented in Union Budget 2020-21 on 1st Feb'20, however, could be very different from these estimates.

Exhibit 7: Detailed projections for central government finances

Macro indicators	Unit	FY16	FY17	FY18	FY19P	FY20BE	FY20F*	FY21F
Total receipts	**INR b**	**12,580**	**14,398**	**15,556**	**16,661**	**20,826**	**17,661**	**18,405**
	% YoY	**9.1**	**14.4**	**8.0**	**7.1**	**25.0**	**6.0**	**4.2**
Revenue receipts	INR b	11,950	13,744	14,352	15,632	19,628	16,961	17,305
	% YoY	8.5	15.0	4.4	8.9	25.6	8.5	2.0
Gross taxes	INR b	14,567	17,160	19,190	20,802	24,612	21,008	23,108
Net tax collection	INR b	9,438	11,016	12,425	13,170	16,496	13,550	14,905
	% YoY	4.4	16.7	12.8	6.0	25.3	2.9	10.0
Direct tax receipts	INR b	7,419	8,497	10,027	11,252	13,350	11,598	12,800
	% YoY	6.6	14.5	18.0	12.2	18.6	3.1	10.4
Indirect tax receipts	INR b	7,148	8,663	9,163	9,550	11,262	9,410	10,308
	% YoY	29.9	21.2	5.8	4.2	17.9	(1.5)	9.5
Non-tax collection	INR b	3,142	3,382	3,131	3,491	4,330	4,111	3,500
Non-tax receipts	INR b	2,513	2,728	1,927	2,462	3,132	3,411	2,400
RBI dividends	INR b	659	659	407	680	900	1,780#	700
Non-debt capital receipts	INR b	630	654	1,204	1,029	1,198	700	1,100
Disinvestment	INR b	421	477	1,000	850	1,050	600	1,000
Total expenditure	**INR b**	**17,908**	**19,752**	**21,418**	**23,114**	**27,863**	**24,699**	**26,325**
	% YoY	**7.6**	**10.3**	**8.4**	**7.9**	**20.5**	**6.9**	**6.6**
Revenue spending	INR b	15,378	16,906	18,793	20,085	24,478	21,811	23,175
	% YoY	**4.8**	**9.9**	**11.2**	**6.9**	**21.9**	**8.6**	**6.3**
Interest payments	INR b	4,417	4,807	5,290	5,827	6,605	6,016	6,500
Capital spending	INR b	2,530	2,846	2,625	3,030	3,386	2,887	3,150
	% YoY	**28.6**	**12.5**	**(7.8)**	**15.4**	**11.8**	**(4.7)**	**9.1**
Fiscal balance	INR b	(5,328)	(5,354)	(5,863)	(6,454)	(7,038)	(7,038)	(7,920)
	% of GDP	**(3.9)**	**(3.5)**	**(3.4)**	**(3.4)**	**(3.3)**	**(3.5)**	**(3.5)**
Nominal GDP	**INR b**	**137,719**	**153,624**	**170,950**	**190,102**	**211,006**	**203,979**	**223,357**
	% YoY	**10.5**	**11.5**	**11.3**	**11.2**	**11.0**	**7.3**	**9.5**

P = Provisional, BE = Budget estimates and F= forecasts

Including interim dividend of INR300b in FY20

* Based on actual data up to Nov'19

Source: Union Budgets documents, CSO, MOFSL

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