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EcoScope
The Economy Observer

Budget 2021 Preview: Expect limited fiscal support

Fiscal deficit could narrow to 5.5% of GDP in FY22 from ~7% in FY21

- **The Government of India (GoI) would present the Union Budget 2021–22 on 1st February 2021. As always, expectations are running high. However, the government's fiscal response in 2020 indicates certain inflexibility and the lack of resources to stimulate the economy.**
- **Although there was no massive fiscal stimulus in CY20—various estimates put it between 1.5% and 2.5% of GDP, of which 0.7% of GDP was on account of food subsidies, which is unlikely to affect the fiscal balance—a significant shortfall in receipts likely led to the doubling of the fiscal deficit to ~7% of GDP in FY21 (from the budgeted 3.5%). The assumption (based on actual data available up to Nov'20) is gross taxes would decline 5.3%, total receipts would fall 12.4%, and total expenditure would grow 7.2% in FY21.**
- **Assuming 19% growth in total receipts in FY22, an increase of just 5.6% in total spending by the central government implies the fiscal deficit could narrow to 5.5% of GDP next year. This indicates that primary spending (excluding interest payments) would grow just 4.6% in FY22 (v/s 6% growth in FY21), marking the second lowest growth in four decades.**
- **Besides these all-important macro numbers, we would closely track the upcoming Budget for any announcements in three areas. 1) The lack of receipts has led to debates related to one-off cess/surcharge. However, GoI may consider keeping the taxation regime unchanged, helping to sustain and bolster the economic momentum. 2) We would closely monitor whether the Union Budget includes measures to revive residential real estate demand in the country. 3) It would be interesting to note whether GoI can continue to support the rural sector as much as it has in the past couple of years.**
- **Lastly, we reiterate that while the GoI is expected – as witnessed every year – to grow its capital expenditure (capex) more than total spending, it is severely constrained by the low share (~25%) of discretionary/non-mandatory spending. Furthermore, the center's capex is only ~5% of domestic investments in the country.**

The Union Budget 2021–22 would be presented by GoI on 1st February 2021. As always, expectations are running high. However, if one considers the government's fiscal response in an exceptionally weak CY20, along with its commitment to adhere to the reported fiscal deficit targets from previous years, it is easy to believe there is certain inflexibility and the lack of limited resources to stimulate the economy.

Although total receipts were always lower than the targets over FY15-19, fiscal deficit targets were broadly achieved in these years by adjusting total spending

A comparison of budgeted deficit targets (budget estimates or BE) vis-à-vis actual fiscal deficit over FY15–19 suggests that although total receipts were always lower than the targets (in the range of 1–8%), fiscal deficit targets were broadly achieved in these years by adjusting total spending. Of course, due to COVID-19, the fiscal deficit stood at 4.6% of GDP v/s the revised estimate (RE) of 3.8%.

Since the Budget 2020 was presented on 1st February 2020 – before the COVID-19 impacted the Indian economy – FY21 targets turned out to be highly unrealistic. Based on actual data available up to November 2020, it appears that GoI's gross taxes could decline 5.3% in FY21 (v/s BE of 12% growth); total receipts could fall 12.4% (v/s BE of 14.7%); and total expenditure could grow 7.2% this year (v/s targeted growth of 12.7%).

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There was no massive fiscal stimulus in CY20; however, the significant shortfall in receipts likely led to the doubling of fiscal deficit to 6.9% of GDP in FY21 (from the budgeted 3.5%)

Although there was no massive fiscal stimulus in CY20—various estimates put it between 1.5% and 2.5% of GDP, of which 0.7% of GDP was on account of food subsidies, which is unlikely to affect the fiscal balance—a significant shortfall in receipts likely led to the doubling of the fiscal deficit to ~7% of GDP in FY21 from the budgeted 3.5% *(Exhibit 1)*. If so, deficit would be higher than 6.5% of GDP posted in FY10 (during the Global Financial Crisis) and the highest deficit reported by the center in three decades (since the early 1990s).

Exhibit 1: What would the fiscal math look like?

	FY19	FY20	Apr–Nov'20*	FY21F		FY22F	
	INR b	INR b	% YoY	INR b	% YoY	INR b	% YoY
Total Receipts	**16,657**	**17,507**	**-17.9**	**15,339**	**-12.4**	**18,292**	**19.2**
Revenue receipts	15,530	16,821	-17.3	15,039	**-10.6**	17,092	**13.6**
Gross Taxes	20,805	20,099	-12.6	19,028	**-5.3**	21,892	**15.1**
Net Taxes	13,172	13,559	-8.3	12,939	**-4.6**	14,887	**15.1**
Direct taxes	11,252	10,372	-24.4	9,199	**-11.3**	10,449	**13.6**
Corporation Taxes	6,636	5,569	-35.7	4,768	**-14.4**	5,531	**16.0**
Income Taxes	4,617	4,803	-12.3	4,431	**-7.8**	4,918	**11.0**
Indirect taxes	9,552	9,727	-2.0	9,830	**1.1**	11,443	**16.4**
Customs	1,178	1,092	-17.0	1,003	**-8.1**	1,203	**20.0**
Excise Duties	2,310	2,396	47.7	3,134	**30.8**	3,447	**10.0**
Services tax	69	60	99.1	15	**-75.2**	0	**-100.0**
Goods & Services Tax (GST)	5,843	6,015	-16.5	5,469	**-9.1**	6,563	**20.0**
Devolution to states	7,633	6,540	-20.7	6,089	**-6.9**	7,006	**15.1**
Non-tax revenue	2,358	3,262	-46.6	2,100	**-35.6**	2,205	**5.0**
Non-debt capital receipts	1,127	686	-37.5	300	**-56.3**	1,200	**300.0**
Divestment	947	503	-65.9	200	**-60.2**	1,000	**400.0**
Total Expenditure	**23,151**	**26,864**	**4.7**	**28,798**	**7.2**	**30,400**	**5.6**
Primary expenditure	17,325	20,753	3.0	21,998	**6.0**	23,020	**4.6**
Revenue expenditure	20,080	23,496	3.7	25,048	**6.6**	26,350	**5.2**
Interest payments	5,826	6,110	12.2	6,800	**11.3**	7,380	**8.5**
Defense	1,925	2,075	-6.6	1,972	**-5.0**	2,071	**5.0**
Subsidies	2,433	2,754	-9.9	2,600	**-5.6**	2,900	**11.5**
Pensions	1,465	1,679	-8.4	1,746	**4.0**	1,891	**8.3**
Grants to states/UTs	3,994	4,470	n/a	n/a		n/a	
Non-defense Pay/allowances	2,111	2,346	n/a	n/a		n/a	
Other	2,325	4,061	n/a	n/a		n/a	
Capital expenditure	3,071	3,367	12.8	3,750	**11.4**	4,050	**8.0**
Fiscal Deficit	**6,494**	**9,356**	**10,755**	**13,459**		**12,109**	
Fiscal Deficit (% of GDP)	**3.4**	**4.6**		**6.9**		**5.5**	
Revenue Deficit	**4,550**	**6,675**	**8,525**	**10,009**		**9,259**	
Revenue Deficit (% of GDP)	**2.4**	**3.3**		**5.2**		**4.2**	
Primary Deficit	**668**	**3,246**	**6,921**	**6,659**		**4,729**	
Nominal GDP	**190,102**	**203,398**		**194,042**	**-4.6**	**218,246**	**12.5**

* INR b for deficit numbers

Source: Union Budget documents, Controller General of Accounts (CGA), Central Statistics Office (CSO), MOFSL

What could the spending growth be in FY22? As we mentioned above, GoI appears keen on adhering to the fiscal deficit targets over anything else. Therefore, while the expectation is that the government would substantially grow its spending to support economic activity, this does not seem likely at present.

If GoI targets fiscal deficit of 5.5% of GDP, our base case, this implies an increase of just 5.6% in total expenditure next year, lower than the expected 7.2% growth in FY21

Following an expected contraction of 4.6% YoY in FY21, we expect nominal GDP to grow 12.5% next year. Accordingly, total receipts of the central government could grow 19% in FY22. If GoI targets fiscal deficit of 5.5% of GDP – our base case, this implies an increase of just 5.6% in total expenditure next year, below the expectation of 7.2% growth in FY21. This implies primary spending (excluding interest payments) would grow just 4.6% in FY22 (v/s 6% growth in FY21), marking the second lowest growth in four decades.

Besides these all-important macro numbers, we would closely track the upcoming Budget for any announcements in three areas:

1) The lack of receipts has led to debates related to one-off cess/surcharge. However, GoI may consider keeping the taxation regime unchanged, helping to sustain and bolster the economic momentum.

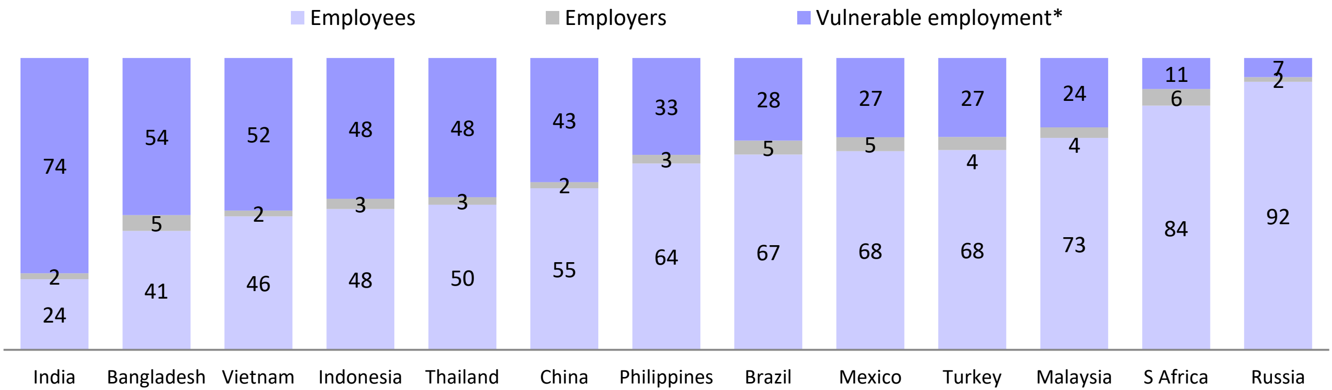
In the last Budget, the GoI had announced new personal income tax slabs and proposed an optional new income tax regime for individuals/HUFs – provided the individuals would not be able to claim most of the allowances and deductions under the new tax regime. We had stated in our **Budget 2020 review** that *the new option may not be highly beneficial for a large section of taxpayers*. We believe this has turned out as expected.

The best way for the government to yield more receipts is to help the economy revive strongly and build further on the momentum achieved over the past 4–5 months

The Union Budget 2021–22 comes in the aftermath of an exceptionally difficult CY20, which saw the government scrambling for funds to spend. Not surprisingly, then, a one-time 'Corona cess' or special surcharge is being considered. Although this would garner some additional resources for the government, it may also risk hurting the strong momentum built up in the economy over the past couple of quarters. As we have discussed in our recently released **note**, economic growth during the past few months has been much better than anticipated. The best way for the government to yield more receipts is to help the economy revive strongly and build further on the momentum achieved over the past 4–5 months. Therefore, GoI may consider keeping the taxation regime unchanged.

We had reiterated in CY20 that the biggest concern related to COVID-19 could be its delayed adverse impact – from the loss of employment and income witnessed by millions of people who are entrepreneurs or casual workers in India. The World Bank defines vulnerable employment as the sum of contributing family workers and own-account workers. A comparison of India with other Emerging Markets (EMs) suggests that almost three-fourths of India's employment is vulnerable – the highest by far v/s other major EMs *(Exhibit 2 on the following page)*.

Exhibit 2: Share of vulnerable* employment in India vis-à-vis other EMs



* Contributing family workers + Own-account workers

Source: International Labour Organization (ILO), MOFSL

This factor puts the Indian economy on a vulnerable path, posing a serious risk. Although economic activity has fared better than expectations in the past few months, it is prudent to not be complacent about the revival.

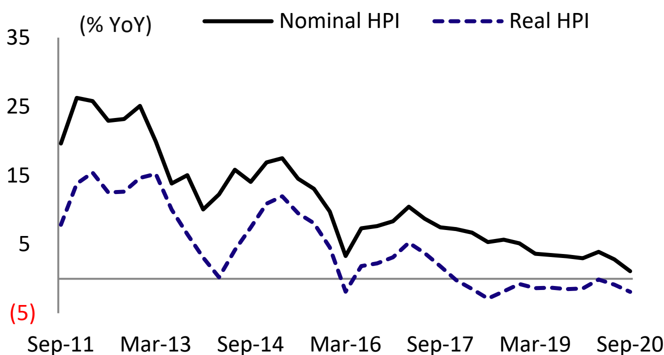
2) We would closely monitor whether the Union Budget includes measures to revive residential real estate demand in the country.

In one of our **detailed notes,** released almost a year ago, we had argued that the Residential Construction sector was at the core of India's economic slowdown. With COVID-19, it was anticipated the Construction sector would remain one of the laggards. The reality, however, has been very different.

Recovery in the Construction sector has been one of the highlights of the post-COVID economy

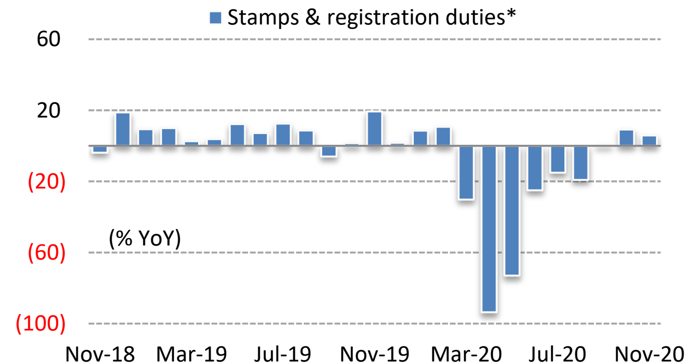
With a) the least adverse effect on regular salaried workers, b) falling real house prices *(Exhibit 3)*, c) a massive reduction in interest rates, and d) the various incentives provided by central/state governments, recovery in the Construction sector has been one of the highlights of the post-COVID economy. Better-than-expected activity is also reflected in the third consecutive month of growth in the stamp duty and registration charges collected by states in Nov'20, for which recent data is available *(Exhibit 4)*.

Exhibit 3: Real house prices have declined marginally in the past three years



Based on transaction-level data from housing registration authorities in ten major cities, deflated by CPI-Housing

Exhibit 4: Better Housing activity has helped states garner higher stamps and registration duties over Oct–Nov'20



* Based on 18 states up to Sep'20, 13 states for Oct-Nov'20

Source: RBI, CAG, CEIC, MoFSL

Residential real estate construction has been weak for years, and a few months of recovery, especially after a sudden halt in mid-2020, hardly changes the overall story significantly

Similarly, cement production and steel consumption – the primary raw materials for construction – have also grown in recent months. However, we strongly believe that it is too early to feel confident about the sustained recovery in residential construction. Residential real estate construction has been weak for years, and a few months of recovery, especially after a sudden halt in mid-2020, hardly changes the overall story significantly.

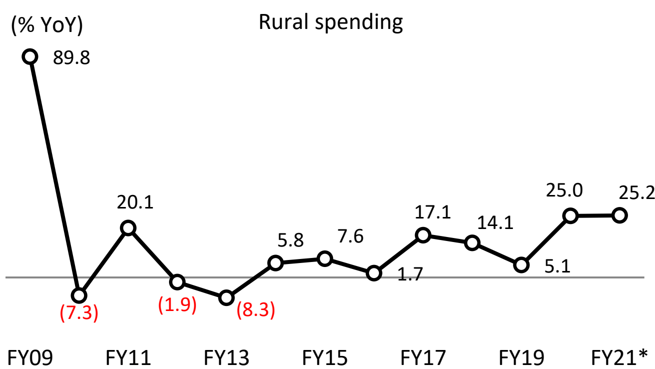
Nevertheless, it seems fairly clear that fiscal incentives are effective. Therefore, we would closely monitor whether the union government proposes any taxes or whether there are other incentives for first-time buyers to help boost the Construction sector.

3) Could the government continue to support the rural sector in 2021–22 as well?

In the last two years, government spending on the Rural sector has increased 25% YoY, taking its share from 11% in FY19 to 15.6% of total expenditure over Apr–Nov'20

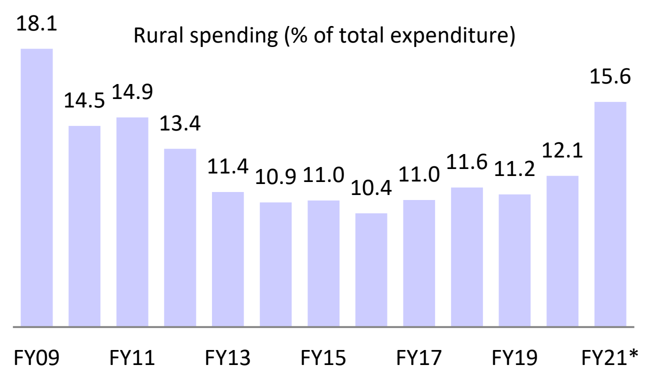
Apart from the GoI's stance on taxes and the Real Estate sector, we would also look at how the government continues to support the rural sector. During the last two years, the central government's spending on the rural sector (comprising the Ministry of Agriculture and Farmers' Welfare, Department of Fertilizers, Department of Drinking Water and Sanitation, Ministry of Panchayati Raj, and Ministry of Rural Development) has increased 25% YoY, taking the share of rural spending to 12% of total expenditure in FY20, from 11% in FY19, and further to 15.6% over Apr–Nov'20 *(Exhibits 5, 6)*. The Mahatma Gandhi National Rural Employment Guarantee Act, 2005 (MGNREGA) scheme saw a sharp increase to INR710b in FY20 (from INR620b in FY19) and further to over INR1t in FY21 (of which the center has already released INR867b as of 18th January 2021). This has certainly helped the nation absorb the reverse migration from urban to rural areas in CY20.

Exhibit 5: Spending in the rural sector has increased 25% YoY in the last two years…



* Data for Apr-Nov'20

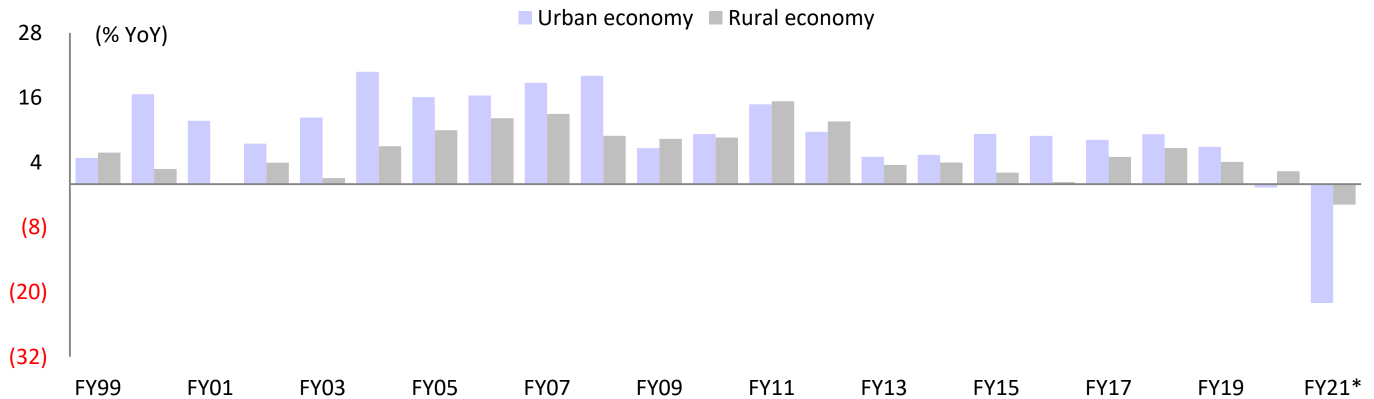
Exhibit 6: …leading to a rise in its share to 15.6% in FY21* from 11% of total expenditure in FY19



Source: Various national sources, CEIC, MOFSL

With normal monsoons, rising food inflation, and government support, the rural sector has managed the pandemic much better than the urban sector—of course, the process of the migration of workers over Apr–Jun'20 was probably one of the most tragic events. Not surprisingly, then, a compilation of various rural and urban economy indicators suggests decline in rural consumption was just ~4% in 1HFY21 vis-à-vis 22% YoY in the urban sector *(Exhibit 7)*. In our recently released **note**, we had highlighted this difference between the rural and urban sectors.

Exhibit 7: Rural economy has managed the pandemic much better than the urban sector



Rural economy indicators: Agricultural wages, Rural non-agricultural wages, Two-wheeler sales, Farm terms of trade, Tractor sales, Agricultural exports, Fertilizer sales, Agricultural credit, IIP: Food products, Water reservoir level, Rail passenger traffic, central government's rural spending
Urban economy indicators: Real salary & wages of listed companies, Non-food CPI inflation, Domestic Passenger Vehicle sales, Personal credit, IIP: Consumer durables, Air passenger traffic, Petrol consumption, Real house prices, Non-farm consumer imports

* 1HFY21 Source: Various national sources, CEIC, MOFSL

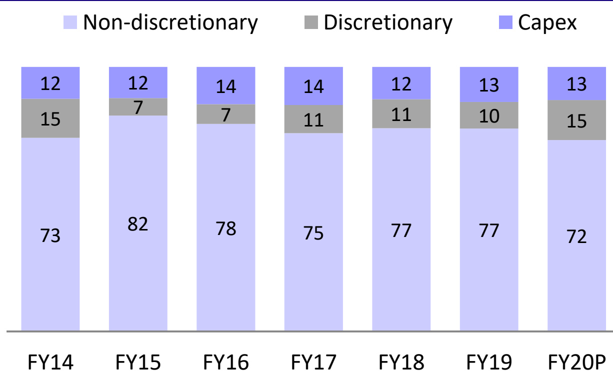
With food inflation easing to 3.5% in Dec'20 from 9–10% YoY for the most part of CY20, government support becomes more crucial in CY21 for the rural sector to continue its outperformance. Therefore, we would keenly monitor government initiatives toward the rural sector in the Union Budget 2021–22.

Limited role of the central government in the country's total investments

Almost half of the discretionary spending is capex, which leaves limited room to accommodate higher capex without expanding the fiscal deficit

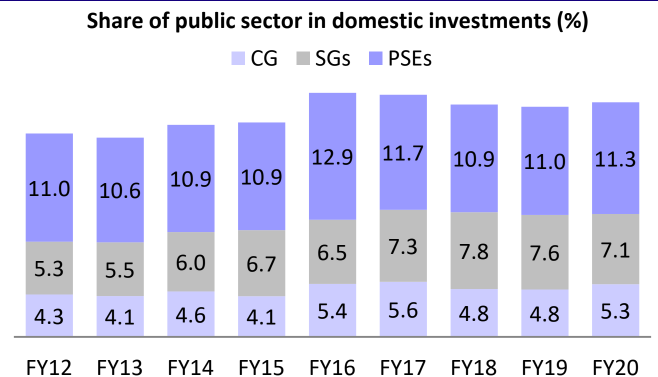
Lastly, we reiterate that while GoI is expected – as witnessed every year – to grow its capital expenditure (capex) more than total spending, it is severely constrained by the low share of discretionary/non-mandatory spending. More than 75% of government spending comprises interest payments, salaries, pensions, defense, subsidies and grants to states /UTs – which qualify as non-discretionary spends, difficult to modify substantially at short notice. Almost half of the remaining comprises capital spending, which leaves limited room to accommodate higher capex without expanding the fiscal deficit *(Exhibit 8)*.

Exhibit 8: Less than a quarter of the center's expenditure qualifies as discretionary spending



Non-discretionary = Interest, pay & allowances (P&A), Pension, defense expenses, subsidies and Grants to states/UTs

Exhibit 9: Center's capex amounts to just ~5% of total investments in the country



FY20 data is our estimate
Source: Central Statistics Office (CSO), CEIC, MOFSL

Furthermore, it is important to note that the center's capex is just ~5% of total investments in the country, reflecting its limited role in the country's investment cycle.

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* MOSL has been amalgamated with Motilal Oswal Financial Services Limited (MOFSL) w.e.f August 21, 2018 pursuant to order dated July 30, 2018 issued by Hon'ble National Company Law Tribunal, Mumbai Bench.