

# Budget 2017-18



## What to expect from Union Budget 2017-18?

### Relief to tax payers and a targeted pro-poor scheme most likely

The Union Budget 2017-18 is scheduled to be released on 1<sup>st</sup> February 2017.

- Uncertainty looms large ahead of the budget, especially with the economic impact of demonetization still unfolding and the timing of GST implementation yet not clear. However, with the government garnering additional resources post demonization, the market holds high expectations from the budget.
- We believe that to strike a balance between economics and politics, the government could use half of the additional resources to provide relief to (individual/corporate) tax payers and the other half for major pro-poor schemes (under revenue spending). Also, in our view, the government would not want to breach its self-committed deficit target of 3% of GDP for FY18 to uphold its credibility in the market and among the ratings agencies.
- The upcoming budget will be a key event from an equity market perspective. We believe the expected measures to reduce tax liability for individuals may provide a much-needed boost to the consumer-related sector. Companies with higher rural exposure (such as HMN, HUVR, Colgate, Dabur, JYL, Hero Motocorp, TVS Motor and M&M) could be the potential beneficiaries, in our view. Furthermore, higher capital spending may help the defense, road and railways sectors. Bharat Electronics, L&T, Bharat Forge, and Cummins are our top picks (refer the table on Page 3 for details on the potential beneficiaries of the Union Budget 2017-18).

The impact of the Indian government's recent demonetization drive on economic activity is yet to be fully ascertained. Our monthly economic activity index (EAI) indicates that the Indian economy grew 6.2% YoY in November 2016 (the month in which demonetization was announced), as against +6.8% YoY in October 2016 (and average growth of 6.6% in 1HFY16). Although official macroeconomic data do not show any significant drag on economic growth, we believe the confidence level has been impacted to a certain extent. This is visible in some high-frequency surveys such as PMI, which declined from 55.4 in October 2016 (composite index) to a three-year low of 47.6 in December 2016. The resultant uncertainty has forced some participants to defer their high-ticket consumption/investment plans. This is evident from two-wheeler sales, which fell to a six-year low in December 2016.

- Maintain fiscal deficit target at 3% of GDP for FY18
- Expect additional resources to be utilized for (individual/corporate) tax sops and one pro-poor spending scheme
- Net borrowings likely to fall further to INR4.1t (or 2.4% of GDP) in FY18
- **Potential beneficiaries:**  
Consumer/retail sector: HMN, HUVR, Colgate, Dabur, JYL  
Auto sector: Hero Motocorp, Tata Motors, M&M  
Capital goods sector: L&T, BEL, Bharat Forge

### Exhibit 1: Motilal Oswal's expectations on key fiscal indicators from Union Budget 2017-18

Economic indicators	Unit	FY15	FY16	FY17BE	FY17MO	FY18MO
Gross fiscal deficit	INR b	5,107	5,351	5,339	5,342	5,131
	% of GDP	4.1	3.9	3.5	3.5	3.0
Gross market borrowings	INR b	5,920	5,850	5,820	5,820	6,672
	% of GDP	4.7	4.3	3.9	3.9	4.0
Net market borrowings	INR b	4,532	4,406	4,082	4,082	4,105
	% of GDP	3.6	3.2	2.7	2.7	2.4
Nominal GDP	INR b	124,882	135,761	150,695	150,695	168,778
	% YoY	10.8	8.7	11.0	11.0	12.0

MO= Motilal Oswal's estimate

Source: Union Budget documents, MoSL

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**Investors are advised to refer through important disclosures made at the last page of the Research Report.**

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However, we believe the monetary authority has very limited room to cut interest rates further

Nevertheless, with the central government garnering additional resources post demonetization, expectations of a significant fiscal stimulus are very high.

Against this backdrop, the markets, not surprisingly, are expecting some relief from the policy makers. However, we believe the monetary authority has very limited room to cut interest rates further. We expect a maximum of one rate cut of 25 basis points (bp) over next 12-15 months. The Reserve Bank of India (RBI) could cut rates next month (or in April 2017) before taking a prolonged pause. Nevertheless, with the central government garnering additional resources post demonetization, expectations of a significant fiscal stimulus are very high. Thus, in this note, we present our expectations from the Union Budget 2017-18.

Our two key expectations from the Union Budget are: (1) reduction in tax liability for individuals, which should provide a boost to the consumer sector, and (2) higher capital spending, which should benefit sectors such as defense, roads and railways. Please see the table on the next page, which highlights sector-wise expectations, as well as the potential beneficiaries if those expectations are met.


**Exhibit 2: Motilal Oswal's expectations from Union Budget 2017-18 in numbers**

	FY16A	FY17BE		FY17RE*			FY18BE*		
	INR b	INR b	% of GDP	INR b	% YoY	% of GDP	INR b	% YoY	% of GDP
<b>Total Receipts</b>	<b>12,409</b>	<b>14,442</b>	<b>9.6</b>	<b>14,759</b>	<b>18.9</b>	<b>9.8</b>	<b>17,281</b>	<b>17.1</b>	<b>10.2</b>
Revenue receipts	11,953	13,770	9.1	14,289	19.5	9.5	16,576	16.0	9.8
Gross Taxes	14,569	16,309	10.8	17,550	20.5	11.6	19,695	12.2	11.7
Net Taxes	9,446	10,541	7.0	11,355	20.2	7.5	12,802	12.7	7.6
Direct taxes	7,348	8,471	5.6	8,302	13.0	5.5	9,240	11.3	5.5
Corporation Taxes	4,545	4,939	3.3	4,820	6.1	3.2	5,243	8.8	3.1
Income Taxes	2,803	3,532	2.3	3,481	24.2	2.3	3,997	14.8	2.4
Indirect taxes	7,221	7,838	5.2	9,248	28.1	6.1	10,455	13.0	6.2
Customs	2,103	2,300	1.5	2,264	7.6	1.5	2,513	11.0	1.5
Excise Duties	2,872	3,187	2.1	4,100	42.8	2.7	4,920	20.0	2.9
Services tax	2,114	2,310	1.5	2,605	23.2	1.7	3,022	16.0	1.8
Non-tax revenue	2,508	3,229	2.1	2,934	17.0	1.9	3,774	28.6	2.2
Non-debt capital receipts	456	671	0.4	470	3.1	0.3	705	50.0	0.4
Divestment	247	565	0.4	423	71.0	0.3	599	41.7	0.4
<b>Total Expenditure</b>	<b>17,733</b>	<b>19,781</b>	<b>13.1</b>	<b>20,100</b>	<b>13.4</b>	<b>13.3</b>	<b>22,412</b>	<b>11.5</b>	<b>13.3</b>
Total excl. Subsidies	15,155	17,466	11.6	17,786	17.4	11.8	20,097	13.0	11.9
Revenue expenditure	15,380	17,310	11.5	17,630	14.6	11.7	19,571	11.0	11.6
Interest payments	4,417	4,927	3.3	4,927	11.5	3.3	5,518	12.0	3.3
Defense	1,432	1,628	1.1	1,628	13.6	1.1	1,790	10.0	1.1
Subsidies	2,578	2,314	1.5	2,314	-10.2	1.5	2,314	0.0	1.4
Grants to states & UTs	1,082	1,184	0.8	1,184	9.4	0.8	1,302	10.0	0.8
Pensions	957	1,234	0.8	1,234	28.9	0.8	1,295	5.0	0.8
Pay & allowances	1,717	1,979	1.3	2,529	47.3	1.7	2,681	6.0	1.6
Assistance to States & UTs	2,018	2,276	1.5	2,276	12.8	1.5	2,503	10.0	1.5
Other	1,178	1,770	1.2	1,540	30.7	1.0	2,167	40.7	1.3
Capital expenditure	2,353	2,470	1.6	2,470	5.0	1.6	2,841	15.0	1.7
<b>Fiscal Deficit</b>	<b>5,324</b>	<b>5,339</b>	<b>3.5</b>	<b>5,342</b>		<b>3.5</b>	<b>5,131</b>		<b>3.0</b>
<b>Revenue Deficit</b>	<b>3,427</b>	<b>3,540</b>	<b>2.3</b>	<b>3,342</b>		<b>2.2</b>	<b>2,995</b>		<b>1.8</b>
<b>Nominal GDP</b>	<b>135,761</b>	<b>150,651</b>		<b>150,651</b>	<b>11</b>		<b>168,729</b>	<b>12</b>	



\* Motilal Oswal's estimate

Source: Union Budget documents, MoSL


## Key budget expectations

Sector	Current state of the sector	Major budget expectations	Expected change, if expectations are met	Key stocks to watch out for
<b>Auto</b> 	❖ Demand environment remains weak across 2W/PV, impacted by demonetization, with -5%/2% growth in 3QFY17.	✓ Considering the likely GST implementation from July 2017, we do not expect any changes in indirect taxes. However, we expect an increase in income tax exemptions and higher allocation toward rural-focused schemes.	❖ Lower income tax and the focus on rural markets could put 2W industry back on the growth path. This, coupled with the benefit of normal monsoon and 7 <sup>th</sup> Pay Commission, could drive 2W volume CAGR of 10-12% over FY17-19E.	✓ Hero MotoCorp, TVS Motor, M&M
	❖ CV volume growth moderated to ~6% in 9MFY17 and flat in 3QFY17.	✓ Introduction of scrappage scheme, which would incentivize scrapping of trucks older than 10 years.	❖ Scrappage scheme (depending on whether it is mandatory/voluntary and magnitude of incentives) can drive 15-18% CAGR for the CVs (current est. of ~12%).	✓ Ashok Leyland, Bosch
	❖	❖ Focus on the infrastructure segment with higher allocation.	❖ Ramp-up in infrastructure activity will drive demand for Tippers and overall CV demand from ~12% CAGR estimate to 15-18% CAGR over next two years.	❖
<b>Consumer</b> 	❖ Cigarette segment has been showing flat-to-positive volume growth over past three quarters after moderate increase of 10% in excise last year. Demonetization and unfavorable base, however, will affect volumes in 2HFY17.	✓ We expect a blended excise duty increase of ~15%.	❖ We expect ITC to implement a weighted average price hike of 14-15% to pass on the excise duty increase. The company has already taken price increase of ~15% in key brands Gold Flake and Navy Cut toward the end of December in anticipation of excise increase. We model in cig. volume increase of 3% in FY18 as a result of relatively moderate excise increases for two consecutive years.	✓ ITC
	❖ Government allocation toward rural schemes has waned off in the recent period. Rural growth has thus tapered down and is now equal to urban growth (we note in FY15 rural markets were growing at 1.5-1.6x of urban markets). We expect an increase in allocation toward the rural sector due to the weak environment and forthcoming crucial state elections.	✓ Any increase in rural spending/infrastructure spending/tax exemption which can put money in hands of consumers, thereby benefiting the FMCG sector.		✓ Broad implication across our coverage universe; however, rural salience is higher for HMN, HUVR, Colgate, Dabur and JYL.
<b>Financials: NBFC</b> 	❖ PSB banks starved for capital.	✓ Higher capital allocation for re-capitalization of PSU banks.	❖ Would lead to higher credit growth, reviving the investment cycle.	✓ PSU banks
	❖ Slow recovery environment with continued stress in core sectors.	✓ Higher allocation of funds to core sectors like infrastructure, housing and urban development.	❖ Would help in faster recoveries and thus improve asset quality position of the banking system.	✓ PSU banks
	❖ AQR and demonetization have contributed to significantly higher bad loan provisioning.	✓ Higher tax relief/concessions for loan loss provisions.	❖ Improve profitability and would lead to more capital available for lending and reduce regulatory arbitrage.	✓ All banks

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	❖ Muted retail environment.	✓ Boosting retail demand through announcements such as increased interest tax exemptions on home loans (current exemption limit at INR0.2m).	❖ Improved demand for housing (bulk of retail) could revive retail credit growth.	✓ Retail focused banks
	❖ Transitioning from paper money to digital payments.	✓ To increase digital penetration, the Govt may consider tax exemption for a) customers conducting transactions digitally/electronically over a certain limit. b) vendors/merchants exceeding a certain threshold in value of digital transactions.	❖ Reduced operating costs, higher transaction fee income and increased float in the banking system.	✓ Retail focused banks
	❖ Schemes to promote affordable housing.	✓ Expect interest subvention schemes announced by PM to be implemented.	❖ Pick-up in growth rate depending on feasibility of final guideline.	✓ Gruh Finance, Repco Home Finance
	❖ Revision of import duty on gold.	✓ Reduction in gold import duty	❖ Could negatively impact growth rate of gold financiers.	✓ Muthoot Finance, Manappuram Finance
	❖ Reintroduction of infra bonds.	✓ Incentives for issuance of infra bonds.	❖ Pick-up in loan growth.	✓ IDFC Bank
<b>Retail</b> 	❖ Weak environment prevails with low-single-digit SSG for retail companies. Festive season reported moderate sales, and demonetization has further weakened sentiment.	✓ Roadmap to GST with timelines. We also await if any fat tax is imposed on QSRs.	❖ Implementation of GST can eventually boost margins, but will have an initial negative impact as indirect tax incidence is likely to be higher after GST compared to prevailing rates. Fat tax will be a negative for QSRs.	✓ Broad implication across our coverage universe.
<b>Capital Goods &amp; Infrastructure</b> 	❖ Defense: Sector companies await an increase in orders from the government post the thrust toward "Make in India". FY17 budgetary allocation at INR858b for capital spending.	✓ Increased allocation toward capital spending in the budget.	❖ An increase in budgeted spending would be positive for companies as it implies higher ordering and execution.	✓ Bharat Electronics, L&T, Bharat Forge
	❖ Roads: Increased budgetary support in FY17 (INR440b) along with various steps taken by the government have revived the sector.	✓ Roads: Increased budgetary support toward road is expected to maintain continuity in ordering and execution. Proposed spending for FY17E was INR1t.	❖ Higher road ordering and construction would be a positive for the companies in the sector.	✓ L&T, Cummins India
	❖ Railways: Government is taking steps to decongest the existing network, improve safety of passengers and return the railways to profitability.	✓ Rail: Increased budgetary support and in turn spending by the Indian Railways. Proposed capex for FY16 was at INR984b, which is unlikely to be met given tepid growth in 1HFY16.	❖ Higher railway spending is a key positive for rail equipment suppliers and contractors.	✓ L&T, Siemens India, ABB India, Crompton Greaves, KEC Intl.
	❖ Namame Gange: While much ground work has been laid, ordering for the Namame Gange mission is yet to see a pickup in orders. FY17 allocation was at INR23b.	✓ National mission for clean Ganga: Increased allocation to the mission would imply a pick-up in orders and execution for the clean Ganga mission.	❖ Higher allocation toward Ganga clean-up would result in a positive change in orders for companies in the wastewater treatment space.	✓ VA Tech Wabag, L&T, KEC Intl

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	❖ Generation-based incentives (GBI) for the wind sector set to expire in March 2017.	✓ Extension of the GBI benefits by another five years.	❖ Extension of the benefits to lead to strong wind capacity addition in the 13th plan.	✓ Inox Wind, Suzlon Energy
	❖ <b>Air conditioners:</b> Increasing awareness of energy efficiency to drive customers toward higher-rated and inverter air conditioners.	✓ Lower excise duty on 5-star/inverter air conditioners to promote usage.	❖ Positive for companies which have a higher focus on energy-efficient air conditioners.	✓ Voltas, Blue Star, Hitachi Home, Whirlpool
	❖ Basis rate of Income tax currently at 30%	✓ Cut basic rate of corporate tax by 1% to 29%.	❖ Reduce the tax burden for companies.	✓ All companies in the sector
<b>Cement</b> 	❖ Cement dispatches declined 15% MoM in November, and dispatches are expected to decline in double-digits YoY in December. ❖ Demonetization has affected cement dispatches pan-India, except in south due to low base and higher spending in AP/ Telangana. ❖ Prices have been stable, with uptrend in prices observed in north and central regions for Jan-17. ❖ Higher operating cost due to increase in fuel and freight to pressure cement company profitability.	✓ Increased infrastructure spending to benefit the cement sector. ✓ Benefits to low-cost housing to increase demand from individual housing segment, which was impacted by demonetization. ✓ Introduction of clean energy cess of INR400/t in Petcoke	❖ Higher spend toward infrastructure and low-cost housing could boost cement demand. ❖ Implementation of cess would increase cement costs by INR30/tonne.	✓ SRCM, TRCL, Dalmia Cement
<b>Healthcare</b>	❖ No incentive for hospitals and diagnostic centers to undergo accreditation.	✓ 100% deduction on approved expenditure incurred for securing accreditation from National Accreditation Board for Hospitals and Healthcare Providers (NABH), and from National Accreditation Board for Testing and Calibration Laboratories (NABL).	❖ Effective tax rate might reduce	✓ Sun Pharma, Alkem, Lupin, Dr Lal Pathlabs, Thyrocare, Apollo hospitals, Fortis Healthcare
	❖ Priority sector status to Healthcare including Hospitals and Diagnostics Centers.	✓ Status to change from priority sector to infrastructure sector.	❖ Reduction in cost of funds to enhance profitability.	
	❖ 5-year tax benefit on capex for hospital projects.	✓ Tax benefit to extend for 10 years on capex for hospital projects.	❖ Lower effective tax rate for extended period.	
	❖ Weighted deduction of ~200% on approved expenditure incurred on R&D activities.	✓ Allow weighted deduction of ~250% on approved expenditure incurred on R&D activities pertaining to indigenous development of medical technology or bio-technology. Also, extend benefit to expenses outside approved facilities.	❖ Encourage higher spend on R&D; lower effective tax outgo.	
	❖ Inverted duty structure, that is, higher rate of excise duty on inputs and lower rate of excise duty on finished goods.	✓ Streamline the duty structure by reducing the duty structure on API so as to have better utilization of credit.	❖ Lower duty would enhance profitability	



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<b>Media</b> 	❖ Effective service tax: 15%; ent. tax: 6-7%; customs duty on set top boxes: 10%.	✓ GST subsuming ST and ET to help aid margins of distribution platforms.	❖ Measures to improve competitiveness of domestic set top box manufacturers.	✓ Zee Entertainment Enterprises ✓ Dish TV
<b>Metals/Mining</b> 	❖ Rise in LME aluminum prices has led to restart of closed/new aluminum capacities in China. This can pose a risk on global demand-supply balance if demand does not catch up with expected rise in supply.	✓ Aluminum companies are expecting an increase in custom duty (current 7.5%) or imposition of minimum import price on aluminum and scrap.	❖ An increase in duty will drive higher realization for domestic aluminum companies. Volumes could also increase as consumers shift to cheap domestic aluminum.	✓ Hindalco, Nalco, Vedanta
	❖ Import of steel products has declined significantly with anti-dumping/MIP measures against imports. However, domestic demand remains tepid amid weak capex/construction activity. Demonetization too has impacted near-term demand.	✓ Higher allocation toward infrastructure spending, which in turn will boost demand for steel products.	❖ Steel product demand will get a boost from the current ~4-5% run-rate.	✓ Tata Steel, SAIL, JSW Steel
	❖ Domestic iron ore production has increased significantly on resumption of mining post the MMDRA Act. There is a 30% export duty on iron ore. Lower grade (less than 58%) ores have nil export duty.	✓ The nil export duty should be extended to at least 60% Fe content iron ore grades from current less than 58%.	❖ Boost exports of iron ore and improve domestic demand-supply balance.	✓ NMDC
<b>Technology</b> 	❖ Duality of pressure in traditional services and growing opportunity in emerging technologies have been impacting companies based on portfolios and strategies.	✓ Clarity on whether in-house research & development facility for computer software is covered within weighted deduction of 200%.	❖ ETR to reduce marginally, impact earnings positively.	✓ N.A.
	❖ Margins are under pressure in the near term, led by regulatory risks around H1B visas in the US	✓ N.A.	❖ N.A.	✓ N.A.
<b>E-Commerce</b> 	❖ Increased focus of industry toward monetization and profitability, either through commercialization of assets or cost-optimization initiatives.	✓ Currently, business loss can be carried forward and set-off for a period of 8 years, restricting it if shareholding varies by 51% or more in the year. Shareholding restriction may get exempt for e-commerce.	❖ Reduction in effective tax rate.	✓ Info Edge
	❖ Demonetization is a long-term positive. High spend incurred in customer acquisition, incentivisation and marketing/advertising (function of competitive intensity).	✓ Allowing 200% weighted deduction on scientific research expenditure by e-commerce companies investing heavily in technology.	❖ Reduction in effective tax rate	
<b>Telecom</b> 	❖ Telecom receipts estimated at INR990b for FY16-17, out of which there should be budget deficit of INR30-35b. The biggest amount of INR35b was generated	✓ This year's telecom budget receipts should come down to ~INR50b, excluding INR35b upfront spectrum auction amount in the absence of no auction. The	❖ Key concern: Any spectrum auction in FY18 may force operators to participate and increase capex spends.	✓ Bharti Airtel, Idea, Reliance Communication

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	through the upfront spectrum auctions amount while rest of the amount included INR10b deferred spectrum payment and INR22-24b license and spectrum fee.	increase of INR15b would be toward higher deferred spectrum payment as the two-year moratorium ends for FY15 spectrum acquisition. ✓ There could be additional upside in telecom receipts if telcos decide to pay off high interest govt. debt by refinance spectrum deferred payments or if there is any spectrum auction scheduled for FY18.		
<b>Oil &amp; Gas</b> 	<ul style="list-style-type: none"> <li>❖ Government had increased cess from INR4,500/mt to 20% ad valorem in the last budget.</li> <li>❖ In FY17, the government has ruled out any subsidy burden on OMCs and upstream companies due to low oil prices.</li> <li>❖ Import duty of 5% charged (excluding imports for power generation).</li> </ul>	<ul style="list-style-type: none"> <li>✓ Cess may be reduced to 10%.</li> <li>✓ Expect clarity on modality for FY18; we build in nil subsidy burden for OMCs and upstream.</li> <li>✓ To increase affordability of natural gas (cleaner fuel), we expect removal of 5% customs duty on LNG imports irrespective of the usage.</li> </ul>	<ul style="list-style-type: none"> <li>❖ Positive for CGD companies and LNG importers.</li> <li>❖ Lowering of cess will be positive for upstream companies. Est. ONGC FY18/FY19 EPS to increase by 2%/3%; OINL FY18/FY19 EPS to increase by 3%/4%.</li> <li>❖ No change.</li> <li>❖ Lower import tax will boost gas usage in India, benefiting companies across the gas value chain. Positive for CGD companies and LNG importers.</li> </ul>	<ul style="list-style-type: none"> <li>✓ ONGC, OIL, CAIR IN</li> <li>✓ IOCL, BPCL, HPCL, ONGC, OIL</li> <li>✓ IGL, Gujarat Gas, MGL, PLNG</li> </ul>
<b>Utilities</b> 	<ul style="list-style-type: none"> <li>❖ The Ministry of Power (MoP) has initiated a series of reforms in terms of domestic coal supply improvement, subsidy for LNG for gas power project, DISCOMs restructuring, etc. However, with supply being higher than demand, operating rates remain low.</li> <li>❖ Debt burden at DISCOMs is impacting investing in distribution upgradation.</li> <li>❖ Petcoke substituting demand for domestic coal in the cement industry. Domestic coal has a cess of INR400/t, while there is no cess on petcoke.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Extension of Sec 80-IA till FY20E.</li> <li>✓ Higher capital allocation to schemes like IPDS can support capex of DISCOMs.</li> <li>✓ Cess on petcoke</li> </ul>	<ul style="list-style-type: none"> <li>❖ The measures are more facilitator in nature and would help keep up investment.</li> <li>❖ Network upgrade can help reduce AT&amp;C losses, and increased reach/reliability of supply can drive electricity demand growth.</li> <li>❖ Improve competitiveness of domestic coal for the cement industry.</li> </ul>	<ul style="list-style-type: none"> <li>✓ NPTC, PWGR, JSW Energy, CESC and COAL</li> <li>✓ Coal India</li> </ul>
<b>Agro chemicals</b>	<ul style="list-style-type: none"> <li>❖ Monsoon has been good this year, but on account of demonetization, farmers have been impacted.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Removal of excise duty levied on pesticides, as there is no excise duty on seeds and fertilizers.</li> <li>✓ Incentives to education of farmers on advanced and</li> </ul>	<ul style="list-style-type: none"> <li>❖ Removal of excise duty can significantly improve sales of agro-chemicals, boosting growth for the companies. Education of farmers will be long term positive for the</li> </ul>	<ul style="list-style-type: none"> <li>✓ PI Industries, Insecticides India,</li> <li>✓ Dhanuka Agritech, Monsanto India,</li> <li>✓ Coromandel International</li> </ul>

**Key budget expectations**

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		modern techniques of agriculture, as productivity in India is almost half that of China.	sector.	
<b>Fertilizers</b>		<ul style="list-style-type: none"> <li>✓ Customs duty rationalization for raw materials that go as inputs in phosphatic fertilizers.</li> <li>✓ Urea price correction by 5-10%, so that subsidy portion receivable from government reduces.</li> </ul>	<ul style="list-style-type: none"> <li>❖ Urea price increase will lead to decline in subsidy receivable from government, which will in turn ease out working capital and finance requirements. Customs duty rationalization shall aid in decline in raw material prices, leading to overall volume growth. Currently, while we factor in a volume growth of 12-14% in expectation of normal monsoon, lower raw material prices can expand the same.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Coromandel International</li> </ul>
<b>Seeds</b>		<ul style="list-style-type: none"> <li>✓ Tax sops for investments made in R&amp;D and plant breeding activities since various components take years of investments.</li> </ul>	<ul style="list-style-type: none"> <li>❖ This can result in increase in R&amp;D and developing newer varieties of seeds.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Kaveri Seed, Monsanto India</li> </ul>
<b>Irrigation</b>		<ul style="list-style-type: none"> <li>✓ Further clarity and updates on Pradhan Mantri Krishi Sinchai Yojana. Increase in allocation of various schemes to revive rural economy, which shall indirectly benefit.</li> </ul>	<ul style="list-style-type: none"> <li>❖ Increase in allocation towards various schemes will indirectly boost rural economy.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Jain Irrigation</li> </ul>



## 1 What makes Budget 2017-18 unique?

**Level of uncertainty is higher than in previous budgets:** Almost all budgets come with some degree of uncertainty. It is inevitable because the central government has to make assumptions on GDP growth, which acts as the base for tax collection. However, we believe the Union Budget 2017-18 brings with it much more uncertainty. There are at least four channels, which will lead to additional ambiguity to Union Budget 2017-18 numbers.

Gross tax collection could increase by up to INR200b by assuming additional growth of 1 percentage point (pp) in nominal GDP in FY18

### a. Basis of the Union Budget – nominal GDP growth

The Central Statistics Office (CSO) pegs its advance estimate of nominal GDP growth at 11.9% for FY17, higher than market consensus of ~11% (and ~11.5% pre-demonetization) and our expectation of 10.2%. In fact, the central government assumed nominal FY17 GDP growth at 11% in its Budget 2016-17. With demonetization, 12% growth in nominal GDP appears ambitious and unrealistic, in our view. However, if the central government decides to use the CSO's advance estimates, it could easily peg FY18 nominal GDP growth estimate at 13% (as against market consensus of 12% and our expectations of ~11%). The higher the nominal GDP growth, the higher would be the tax collection assumption, allowing the government to make higher spending allowances. A simple calculation shows that gross tax collection could increase by up to INR200b by assuming additional growth of 1 percentage point (pp) in nominal GDP in FY18. Although this risk is run every time the government presents its budget, the rise in uncertainty due to demonetization has created an additional layer of vagueness to such estimates.

**Exhibit 3: Tax base growth is directly linked with nominal GDP/GVA growth**

% YoY	FY13	FY14	FY15	FY16	FY17AE	FY17MO	FY18MO
GDP	13.9	13.3	10.8	8.7	11.9	10.8	11.2
GVA	13.6	12.7	10.5	7.0	10.8	10.0	10.9
Agriculture	11.9	13.2	4.9	4.9	10.8	7.8	8.9
Industry	10.9	9.4	7.6	6.0	7.4	6.9	8.6
Manufacturing	11.6	9.0	7.6	8.1	9.6	9.0	9.7
Services	16.0	14.6	14.3	8.3	12.7	12.4	12.8
Tax base	14.9	13.2	12.7	8.3	12.0	11.6	12.1

AE= CSO's advance estimate

MO = Motilal Oswal's Estimate

Source: Central Statistics Office (CSO), MoSL

### b. Tax receipts collected through involuntary/undisclosed declaration

One of the side effects of demonetization has been the resurgence of the Income Tax (IT) department, which has been conducting searches on a regular basis. According to the recent information released by the IT department, a number of investigations resulted in an admission of undisclosed income of approximately INR26b, as of [December 16, 2016](#). Further, the IT department [identified](#) a total of ~6.8m potential non-filers, who had carried out high-value transactions in the financial year 2014-15 but did not file returns. These non-filers (~18% of total tax return filers in the economy) could have potential tax liabilities associated with them. At the time of presenting the Union Budget 2017-18, the government is unlikely to have firm information about undisclosed income that could be declared in these cases and the associated level of tax collection. Furthermore, it would be

At the time of presenting the Union Budget 2017-18, the government is unlikely to have firm information about undisclosed income that could be declared in these cases and the associated level of tax collection.

difficult to ascertain the timing of such declarations. This thus creates further ambiguity, in our view.

The multi-layered tax structure proposed under GST – which will get implemented in the middle of a financial year – will bring opaqueness on associated tax collections

Some of the schemes, under which the government could potentially raise tax receipts, would continue till March 31, 2017. Thus, the government's estimates on tax collection on account of these schemes would be open to doubts.

### **c. Impact of Goods & Services tax (GST) on tax receipts**

In a meeting concluded early this week, the GST Council is understood to have reached a consensus on the contentious issue of dual control for administering the tax and defining the boundaries of a state to levy tax. This has instilled some confidence among the market participants that GST could be implemented in July 2017. Although this is one of the most awaited indirect tax reforms in the economy, the multi-layered tax structure proposed under GST – which will get implemented in the middle of a financial year – will bring opaqueness on associated tax collections, at least in the initial few months. Such uncertainty will also make the numbers presented in the Union Budget highly skeptical.

### **d. Will the government include all additional resources?**

All the government spending plans will have to be approved in the Parliament, and the government thus needs to balance all the expenses with the source of financing. Apart from the uncertainties associated with the aforementioned factors, it is also important to note that some of the schemes, under which the government could potentially raise tax receipts, would continue till March 31, 2017. Thus, the government's estimates on tax collection on account of these schemes would be open to doubts. The Pradhan Mantri Garib Kalyan Yojana (PMGKY) 2016 is open up to March 31, 2017. Furthermore, certain branches of the RBI will continue collecting specified bank notes until end-March 2017. Since the RBI functions on July-June year, the actual amount of special dividends that could arise from the extinguishment of the RBI's liabilities would be known at a much later date. Consequently, the Union Budget 2017-18 will come with an additional layer(s) of ambiguity, raising questions on the numbers presented by the government on February 1, 2017.

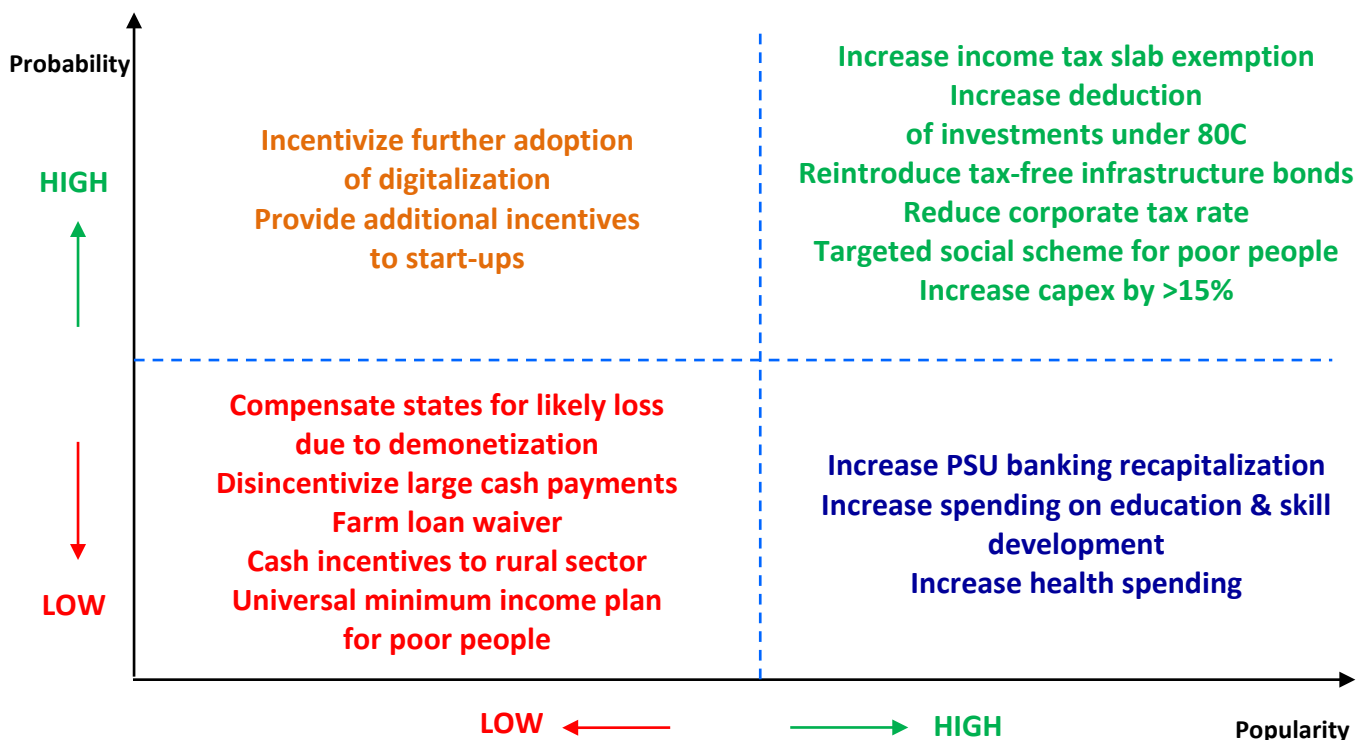
## 2 What is FY18 Union Budget expected to deliver?

All said and done, notwithstanding the additional ambiguity attached with the 2017-18 Union Budget, almost all sections of the society expect the central government to provide some relief.

The government is expected to provide some relief to (individual/corporate) tax payers and announce an exclusive scheme for the poor.

**Expectations of a stimulus have peaked:** *Exhibit 2* below categorizes major expectations from the Union Budget, based on the probability of these measures being adopted and their popularity (measured by its sentimental impact on the financial market). We believe that the government might not announce significant relief to any single section of the society in the budget. This is primarily because the additional resources available are unlikely to be significant enough to finance major relaxations. Nevertheless, the government is expected to provide some relief to (individual/corporate) tax payers and announce an exclusive scheme for the poor.

**Exhibit 4: How do various expectations rank in terms of probability and popularity?**



By Popularity, we imply its potential impact on the stock markets

Source: Union Budget, MoSL

In terms of personal income tax, we believe the Union Budget 2017-18 could be a reflection of the first budget of the current government presented in July 2014.

### a. Expected measures on individual income tax

In terms of personal income tax, we believe the Union Budget 2017-18 could be a reflection of the first budget of the current government presented in July 2014. In our view, some increase in the income tax exemption slab (by INR50,000) and deduction under Section 80C (by another INR50,000) would be announced. We also expect the government to reintroduce tax-free, long-term infrastructure bonds with a limit of up to INR50,000-100,000 per annum. While the first of these three measures may partly help boost consumption, the other two measures will lead to higher savings (replacing) and thus investments.

The upcoming Budget thus would be the perfect time for the government to cut the basic rate on corporate tax by 2pp. However, we believe that a cut in the basic rate by 1pp is more realistic in this Budget.

We believe that the government may announce one major pro-poor program.

With states likely to begin implementation of pay commission awards from FY18, the central government must shift its focus back on capital spending.

## **b. Expected measures on corporate tax**

We also expect the government to act on its commitment to reduce the basic rate of corporate tax from 30% to 25%. The government had promised to cut the basic rate in four years, of which two years have already passed. Demonetization is [expected](#) to have impacted the earnings performance significantly in 3QFY17. The upcoming Budget thus would be the perfect time for the government to cut the basic rate on corporate tax by 2pp. However, we believe that a cut in the basic rate by 1pp is more realistic in this Budget. It would certainly raise questions on the ability of the government to meet its 25% tax rate target by 2018-19.

## **c. Budget measures for the poor**

One of the focus areas of the budget would be the rural sector. It is widely expected that the government would announce few measures to the poor section of the population. A number of measures ranging from [farm loan waiver](#) to [social security program](#) are expected from the government. Furthermore, some sections expect universal/guaranteed minimum income plan for the poor. However, this concept is too [complex](#) (and costly) to be undertaken in the Indian economy and implementation would be a real challenge. In the wake of the UP elections, however, we believe that the government may announce one major pro-poor program. The program, in our view, would likely be a targeted rather than universal measure, consuming almost half of one-time additional resources garnered post demonetization.

## **d. Continuation of emphasis on “less-cash” society**

We also believe that the government would step up its efforts to encourage digitalization and less-cash economy by incentivizing usage of electronic payments (or less likely by [disincentivizing cash usage](#)).

## **e. Central government must boost capital spending**

We also believe that the Union government must increase its investment spending. In the current financial year (FY17), due to the implementation of the 7<sup>th</sup> Central Pay Commission (CPC), revenue spending was budgeted to grow 12.5%, as against ~5% in FY16. Nevertheless, [state governments](#) took the responsibility to increase investment this year. With states likely to begin implementation of pay commission awards from FY18, the central government must shift its focus back on capital spending. Consequently, we expect the government to increase its capex at least by 15% for FY18.

As *Exhibit 2* above shows, there are also few more expectations – increased spending on education, skill development and health, providing compensation to states for the potential loss of revenue due to demonetization, etc. Nevertheless, it would be unfair to expect the government to be able to meet all these expectations.

We would be disappointed if economics is not given due importance in the upcoming Budget.

We would be disappointed if economics is not given due importance in the upcoming Budget. This is because it would, otherwise, tilt the budget more towards populist schemes, which is more likely to be inflationary in nature (*Exhibit 3-4*). In our view, although inflation has eased considerably over past few months, it is likely to average 4.7% in FY17 and move toward 5.5% next year. Consequently, we would expect the government to resist inflationary measures in the budget, which is only possible if economics is given due importance.

Exhibit 5: Strong correlation between central government’s core revenue spending and rural wages...

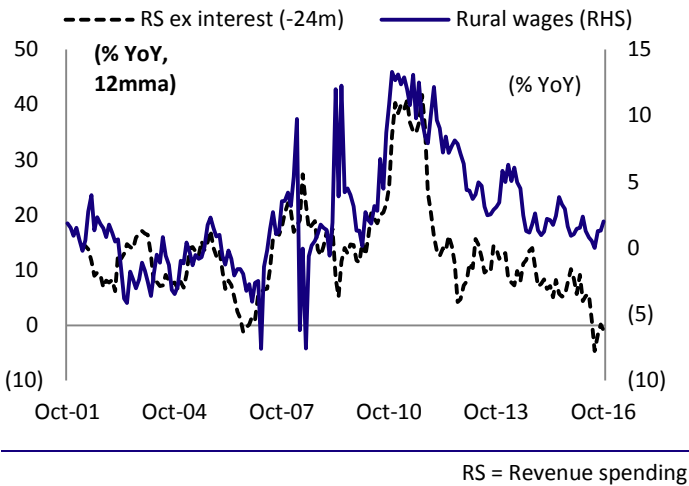
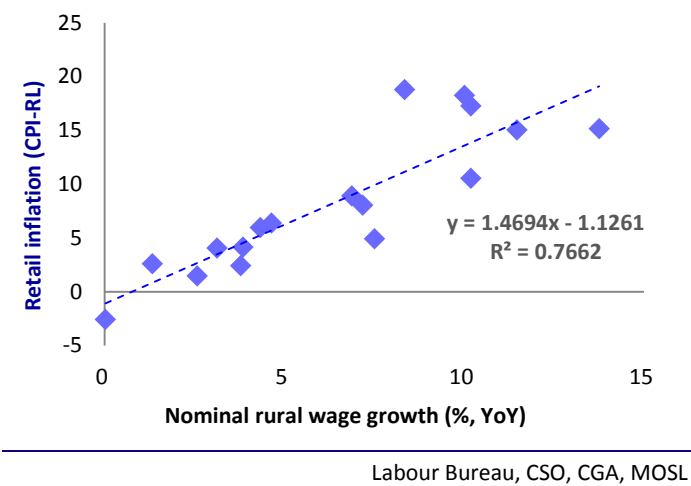


Exhibit 6: ...translates into higher retail inflation for the economy





### 3 How could FY17 data stack up?

The government could end FY17 with total receipts worth INR14.76t, about INR320b higher than the budgeted estimate (BE).

Nevertheless, instead of reducing fiscal deficit, these additional resources would be utilized by the government to make payments under the 7<sup>th</sup> CPC.

We believe that revenue spending growth in FY17 was higher than budgeted, which will entirely offset additional resources garnered this year.

#### Additional resources in FY17 to be utilized for payment under 7<sup>th</sup> Pay Commission...

Our calculations reveal that the government could end up with gross tax receipts amounting to INR17.55t in FY17, as against the budgeted estimate of INR16.3t. After adjusting for devolution of taxes to state governments, the central government could have net tax receipts of INR11.36t in FY17, almost INR810b higher than the budgeted estimate. However, more than half of the higher tax receipts would be offset by lower receipts on account of non-tax revenue and non-debt capital receipts. Thus, the government could end FY17 with total receipts worth INR14.76t, about INR320b higher than the budgeted estimate (BE).

Nevertheless, instead of reducing fiscal deficit, these additional resources would be utilized by the government to make payments under the 7<sup>th</sup> CPC. As we had pointed out in our [report](#) earlier, as against the estimated provision of INR859b, the government provided for only INR247b (~29%) in its 2016-17 Union Budget. Since the decision on the revised rates and the date of effect of all allowances (except Dearness allowance) is not yet notified, we believe the actual provisions provided by the government should have been ~INR800b, which is about INR550b more than what the government had provisioned (since the increase in some allowances is still pending). Therefore, all the additional resources collected would be utilized toward payment under the 7<sup>th</sup> CPC.

Nevertheless, instead of reducing fiscal deficit, these additional resources would be utilized by the government to make payments under the 7<sup>th</sup> CPC.

**...and the government thus will meet deficit target of 3.5%:** The government had decided to make payment of all arrears under the 7<sup>th</sup> CPC with [the salary of August 2016](#). Thus, although the government did not make full provisions of the due payment under 7<sup>th</sup> CPC in the budgeted estimate, we believe that the revised estimates will reflect these payments. Consequently, we believe that revenue spending growth in FY17 was higher than budgeted, which will entirely offset additional resources garnered this year. Consequently, the bottom line (i.e. fiscal deficit) will remain unchanged at 3.5% of GDP (assuming 11% nominal GDP growth).

#### Exhibit 7: Government to maintain FY17 fiscal deficit at 3.5% of GDP

	Budget estimate (BE)	Apr-Dec 2016	FY17MO	Change from BE
<b>Total receipts</b>	<b>14,442</b>	<b>8,287#</b>	<b>14,759</b>	<b>317</b>
<b>Gross taxes</b>	<b>16,309</b>	<b>11,438</b>	<b>17,550</b>	<b>1,241</b>
<b>Net taxes</b>	<b>10,541</b>	<b>8,084</b>	<b>11,355</b>	<b>814</b>
Corporate taxes	4,939	3,192	4,820	(119)
Personal income taxes	3,458	2,317	3,481*	(50)
Union excise duty	3,187	2,446	4,100	913
Customs	2,300	1,660	2,264	(36)
Services tax	2,310	1,618	2,605	295
<b>Non-tax revenue receipts</b>	<b>3,229</b>	<b>1,750#</b>	<b>2,934</b>	<b>(295)</b>
<b>Non-debt capital receipts</b>	<b>671</b>	<b>326#</b>	<b>470</b>	<b>(201)</b>
<b>Total expenditure</b>	<b>19,781</b>	<b>12,867#</b>	<b>20,100</b>	<b>320</b>
<b>Revenue spending</b>	<b>17,310</b>	<b>11,443#</b>	<b>17,630</b>	<b>320</b>
<b>Capital spending</b>	<b>2,470</b>	<b>1,424#</b>	<b>2,470</b>	<b>0</b>
<b>Fiscal deficit</b>	<b>5,339</b>	<b>4,580#</b>	<b>5,342</b>	<b>3</b>

# Up to November 2016

\* Includes INR84b due to IDS 2016

Source: Union Budget, MoSL

## 4 What are our expectations from FY18 Budget?

We firmly believe that the government would not want to hurt its credibility by relaxing its self-imposed fiscal deficit target of 3% of GDP for FY18.

**Expect the government to maintain 3% deficit target:** We firmly believe that the government would not want to hurt its credibility by relaxing its self-imposed fiscal deficit target of 3% of GDP for FY18. There are at least three reasons for this:

- The government has already once relaxed its deficit target two years ago in 2015-16, when it postponed its target to reach 3% by one-year to FY18. We do not think that the government would want rating agencies to raise concerns about the credibility of the government's commitment by relaxing it again.
- With the government expected to receive a significant amount of additional resources in FY18 (~INR730b, according to our calculations) due to demonetization, breaching the deficit target is even more unexplainable.
- In case the government decides to support economic growth at the cost of relaxing its self-imposed deficit target, it will be seen as the government's acceptance of demonetization hurting the economy in FY18. We do not think the government would want to send such signals.

### 4.a. What could be the amount of additional resources collected?

*Exhibit 6* below shows the calculation of additional resources likely to be received by the government due to demonetization. Although PMGKY 2016 is open up to March 31, 2017, most of the declarations are done by December 30, 2016. All tax liabilities, thus, under this scheme would be collected in FY17. Nevertheless, the IT department is expected to remain very vigilant in coming years, disclosing a substantial amount of undisclosed income and thus related tax liabilities.

Demonetization could help the government collect additional taxes worth INR328b in FY18.

### Additional tax collection to be ~INR330b...

It is not possible to project tax receipts from the searches conducted by the IT department. However, for the purpose of making estimates, we assume that the IT department helps unearth income worth INR285b (50% of the income considered to be declared under PMGKY 2016) implying tax receipts of INR242b. Further, based on our assumption of voluntary declarations under PMGKY and involuntary declarations, the individual tax base will widen by 57,000 people earning more than INR10m per annum (more than 45,000 people in 2013-14). This will also garner another INR86b as individual taxes. It implies that demonetization could help the government collect additional taxes worth INR328b in FY18.

### Exhibit 8: The government could garner additional tax receipts of INR730b in FY18

% of non-deposited SBNs till December 19, 2016#	Unit	10	30	50	70	90
Taxable deposits (TD)	INR b	114	342	570	798	1,026
Tax on voluntary disclosure to be collected in FY17 (@50%)	INR b	86	257	428	599	770
Involuntary/Forced disclosure (50% of TD)	INR b	57	171	285	399	513
Tax on involuntary disclosure to be collected in FY18 (@90%)	INR b	48	145	242	339	436
Permanent tax collection from wider tax base in FY18 @15%	INR b	17	51	86	120	154
<b>Total additional tax collection in FY18</b>	<b>INR b</b>	<b>66</b>	<b>197</b>	<b>328</b>	<b>459</b>	<b>590</b>
<b>Special dividends from RBI to be received in FY18</b>	<b>INR b</b>			<b>400</b>		
<b>Total additional resources in FY18</b>	<b>INR b</b>			<b>728</b>		

#As per our calculations, almost INR14.3t (out of INR15.44t) of SBNs were deposited by December 19, 2016

Source: MoSL

**...and RBI could transfer another INR400b as special dividends:**

On December 30, 2016, the government had passed an [ordinance](#) to extinguish the RBI from liabilities related to the specified bank notes. Thus, the amount of SBNs that does not return to the banking system by end-March 2017 could be transferred to the government as special dividends. The question is “How will RBI transfer these extinguished liabilities to the government?”

Since RBI liabilities get extinguished, a matching entry has to occur either by increasing liabilities or by reducing assets. Assuming that the RBI has to transfer the entire portion of extinguished liabilities to the government, either the RBI will credit the government’s account by a similar amount (thereby increasing government’s deposits with the RBI (on liability side)), or the RBI will choose to terminate a portion of short-term government papers maturing within one year, reducing its assets. The former will create additional resources for the government to be utilized in FY18, while the latter will not add anything to the government’s resources but reduce its repayments and thus gross borrowings. We assume that the RBI will decide to keep the size of its balance sheet unchanged and provide special dividends to the government as additional resources to be utilized in FY18.

The RBI could transfer a maximum of INR400b to the government, which will be included in the latter’s non-tax revenue receipts for FY18.

Unfortunately, the RBI had not provided any data on deposited SBNs after December 10, 2016. Nevertheless, our calculations using the currency in circulation data released by the RBI and total supply of currency by December 19, 2016 data provided by the RBI show that more than INR15t is back into the system. Thus, the RBI could transfer a maximum of INR400b to the government, which will be included in the latter’s non-tax revenue receipts for FY18.

Thus, additional tax resources worth INR328b and non-tax revenue of INR400b will add INR728b to the government’s kitty next year.

Almost half of these additional resources (INR380b) are expected to be used to provide relief to (individual/corporate) tax payers, while the other half (INR350b) could be used for the major pro-poor schemes (under revenue spending).

**4.b. How could these additional resources be utilized?**

**Government unlikely to be able to meet high expectations...:** With the government collecting additional resources of about INR730b in FY18, it is highly unlikely for the government to be able to meet high expectations of providing stimulus to almost all sections of the society. Almost half of these additional resources (INR380b) are expected to be used to provide relief to (individual/corporate) tax payers, while the other half (INR350b) could be used for the major pro-poor schemes (under revenue spending).

- a. As we discussed above, on the individual tax front, the government could announce the same measures which were announced in its first budget three years ago. A combination of an increase in the income tax exemption limit by INR50,000 to INR300,000 and an increase in deduction under section 80C by INR50,000 to INR200,000 could provide a respite worth INR230b to individual tax payers.
- b. Further, although the government has only two years left to meet its commitment to reduce the basic rate of corporate tax by 5pp, we expect a reduction of 1pp in the corporate basic tax rate to 29% in the upcoming Union Budget. This could cost INR156b to the exchequer.

- c. Finally, although the shape and the form of a pro-poor stimulus are difficult to envisage, we believe that there will be one major package directed toward the poor population. Since the government will have about INR350b with it, this directly rules out any farm-loan waiver or universal income plan, which would certainly cost way much higher. As we discussed above, some sort of targeted policy will be announced for the poor population.

**Exhibit 9: Utilization of additional resources received due to demonetization in FY18**

	Amount (INR b)	Comments
<b>Total additional resources</b>	<b>728</b>	
Tax receipts	328	Please see <i>Exhibit 6</i> above
Non-tax receipts	400	
Individual income tax relief	~230	Increase in income tax exemption limit by INR50k Increase in deductions under 80C BY INR 100k to 250k Re-introduce tax-free infrastructure bonds of INR50k-100k
Corporate tax relief	~156	Cut the basic rate of corporate tax by 1%
Higher revenue spending	350	Available resources to announce one major pro-poor (targeted) scheme

**What must be ignored?**

A universal minimum income plan/ or a new program on the lines of MGNREGA

**What would be more desirable?**

Disproportionately higher spending on education, health, etc.

Source: MoSL

Overall, we do not believe that some big-bang fiscal stimulus is in store – not possible unless the government compromises with the fiscal deficit target (a relaxation of 0.1% of GDP in the deficit will free ~INR170b for the government). Given below are our key expectations/hopes from the Union Budget 2017-18:

1. No extraordinary increase in the income tax exemption slab (expect it to be increased by INR50,000 to INR300,000).
2. A token reduction in the basic rate of corporate tax by 1pp to 29%.
3. Unlikely to finance a farm-loan waiver or a universal/guarantee income plan.
4. Expected to announce a pro-poor package costing about INR350b.
5. Hope to increase capex by 15% (or higher).

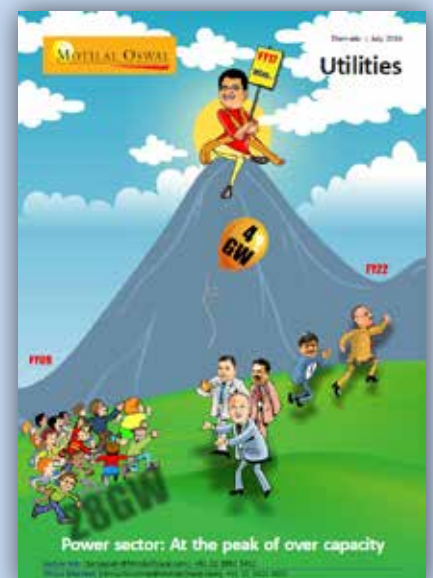
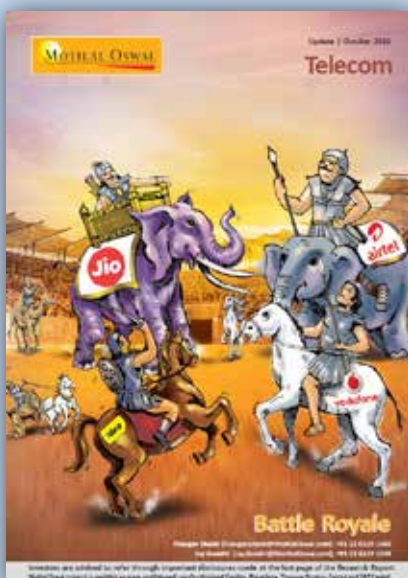
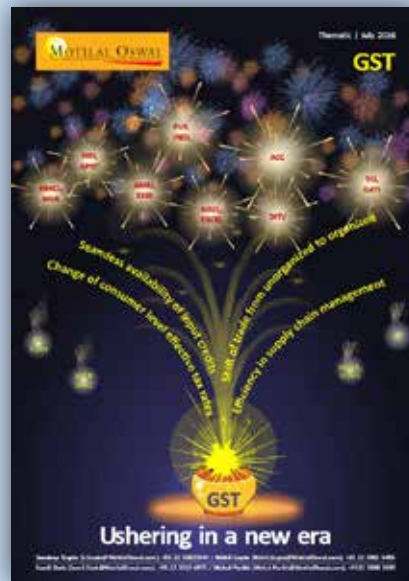
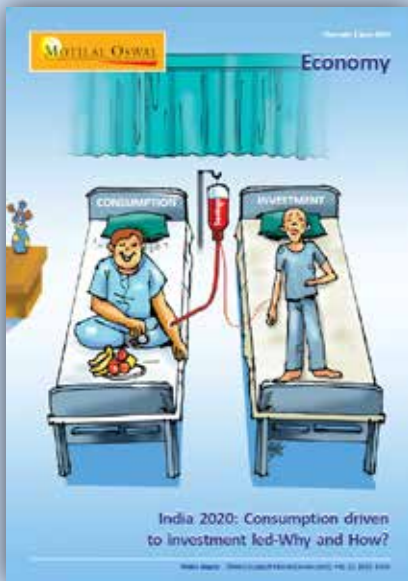
Such small but effective measures will help boost sentiment. Interestingly, this combination will also help balance out the consumption and investment theory. A large part of the relief to tax payers and higher capex by the central government will likely add to savings/investment, while the pro-poor scheme is expected to give a push to consumption.

While these schemes will help boost sentiment across the economy, it is unlikely to be converted into higher GDP growth,

While these schemes will help boost sentiment across the economy, it is unlikely to be converted into higher GDP growth, as we have argued in one of our recently released [report](#). This is primarily because the Union Budget 2017-18 will effectively be redistribution of wealth rather than a real fiscal stimulus. The budget thus is not expected to have an impact on FY18 GDP growth.



# THEMATIC/STRATEGY RESEARCH GALLERY





NOTES

## Disclosures

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