BUDGET 2015: NO DRASTIC SURGERY BUT REHABILITATION

Transcript of the speech given by
Mr. Raj Nair, Chairman, Avalon Consulting
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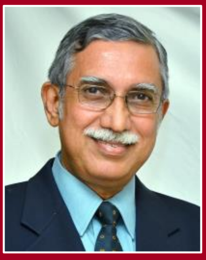
– Raj Nair

ABOUT THE AUTHOR



As a strategy consultant, Raj has helped companies across diverse industries in India, USA, Europe, and the Middle East to develop strategies, align strategy to vision, grow in competitive markets, restructure to make companies more customer focused etc.

In his current role, Raj serves as - Chairman: Avalon Consulting, Director: OC&C Strategy Consultants India, Chairman: Ugam Solutions Pvt Ltd., Chairman: Avalon Global Research and Chairman: Germinait Solutions Pvt Ltd.

In his previous roles, Raj has worked as a Merchant Banker with Grindlays Bank and has also worked in the Consumer Durables industry

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BUDGET 2015: NO DRASTIC SURGERY BUT REHABILITATION

By **Mr. Raj Nair,** Chairman of Avalon Consulting

I will stay clear of taxation aspects of the Budget 2015 since there are two experts on today's panel talking on direct and indirect taxation. I will focus on the economic impact of the Budget. We were all eagerly waiting to see what the Government intends to do in order to revive the economy. There were huge expectations in many quarters. The markets were completely confused as the Budget speech rolled out the details as you could see from the volatile swings on February 28. It may take a week or two for sanity to return. In the limited time available to me I want to go under the skin of the announcements to explain what it means for the economy without getting too technical or listing all that the Finance Minister said.

The options available ranged from consolidating by drastically reducing deficit financing to going overboard on it to spur economic growth even at the cost of inflation, neither of which would be the right medicine for the patient. The solution would have to depend upon the context and the goals.

- The goals are to make the economy strong, eliminate poverty, improve the lives of citizens through more employment, better healthcare, more housing, more access to good education and nutrition, etc.
- What is the context? Don't forget that in 2013 India was a sick patient who had almost lost self-confidence. How do you expect that patient to be able to get up and run just because politicians announced that Ache Din are coming?

India was not terminally ill but the previous Government did reduce India into a patient with chronic illnesses, a patient who lacked the money for treatment and whom long term global funding was not easily available. This patient had developed certain bad habits like not earning enough to pay his regular bills, living in unhealthy conditions and expecting not to contract diseases, indulging in harmful habits that would weaken the system (mindless subsidies) instead of investing the same money on building the body's ability to not just handle various diseases that are there in the air but also to eventually be able to actually grow strong to get up and run.

Sloganeering had built unrealistic expectations of some magic cure. Our general optimism was reflected in the share market's bull-run. Hence there is bound to be some disappointment when reality sinks in despite the fact that the treatment being administered is good. The market wanted a heart transplant, a liver transplant and a kidney transplant, all at once. The good doctor is telling us that patient need not undergo such drastic surgery, and that he can be brought back to good health with some bypass surgery and some steady pre- and post-operative medical care.

We see such situations very often in our own families. There are many well-wishers who proffer conflicting advice but eventually you reconcile with what the doctors say and cautiously hope for the best. That is exactly what you and I need to do regarding the treatment being given to the Indian economy. We should feel reassured that we have taken the patient from a small clinic to a decent hospital and not get upset that the doctors are not doing multiple organ transplant.

- The heart is OK, arteries not totally blocked, but we need more blood and also need to remove clogs for it to flow.
- The liver is fatty and not helping to absorb nutrients from the digestive system but it is a unique organ that can be completely regenerated with some care.
- The kidneys are weak and they need some intervention for them to remove toxins more effectively. Remember also we have a spare kidney even if one is bad.

So do the policies that are embedded in this Budget suggest that the patient is likely to get very healthy again soon? Some people are sceptical, some very optimistic but I am cautiously optimistic.

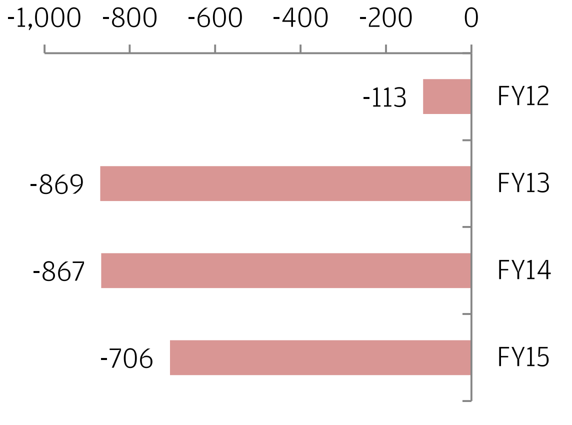
Fortunately, in this budget has planned for a lower deficit year (3.9%) versus year (4.1%) despite the temptation to fuel growth without financial discipline to serve political ends. That is fine but what is being done to solve the basic problems?

The Heart: By Pass

Three major blood clogs to be targeted and some minor ones:

First clog: Not enough money was flowing into capital expenditure in the recent times. At one time it was 3% of the GDP but by FY 2013-14, it had dropped to 1.5%. In this Budget, the plan is to increase it to 1.7% which is a 25% increase in actual Rupee terms, a big jump from an increase of 2.5 % in the previous year. In fact, the Central Plan outlay in this Budget is up by 35.5% as compared with an average annual fall of 3.4% in each of the past 3 years! With that, the demand for capital goods and products and services from several sectors can be expected to revive. There will be more new jobs. Hopefully the increase in capital expenditure will happen fully as planned. I am a bit worried because of India's track record in not achieving the planned revenue collection which then curtails the actual capex figure. See chart below:

Cut in Productive Expenditure



Source: Budget Documents

The redeeming feature is that the budgeted expenditure is much higher than in the past and that the Government has already started to mop up additional taxes from petrol and diesel, given that the oil price drop has given a head room of more than Rs 10 billion.

Capex will be the first item to get squeezed out if revenues from disinvestment or tax collections fall or if subsidies swell on account of any reason (oil price increase, political expediency in a year when there are elections in some states, etc.). A lot of the gain from the oil price fall has been earmarked for capex but if the oil prices rise again beyond what is assumed in the budget there would be trouble.

The second clog: The flow of funds for productive use was being severely blocked by oil import bill and gold imports, the two biggest items causing our Current Account Deficit (luckily down now to about 1.3 %) thus reducing our ability to import other good essential for the growth of our economy and also weakening the Rupee. Our gold imports have been in the region of 800 to 1000 tonnes pa. At the same time, there is an estimated 20,000 tonnes in India much of it lying idle. When it is idle there is no income on it but it also means that more has to be imported to satisfy the craze to buy gold in India. A favourable wind blew away the oil prices, at least for now and the Government has retained the 10% import duty and has now planned a Sovereign Gold Bond Scheme, Gold Monetisation Scheme and an Indian Gold Coin which can reduce gold imports drastically. The sooner this is implemented the better. I had suggested some of this in a talk at the Indian Merchants Chamber over a year ago.

Third clog: Non-availability of favourable factors of production is throttling manufacturing sector. The share of the manufacturing sector has steadily declined to about 16% of the GDP. We have a lofty goal: Make in India but do we have the right strategy to bring manufacturing into India when there are at least 20 emerging countries wanting to do the same? Does the budget reflect policies that recognise we need in order to become competitive?

- That means we need to have more people productivity. Better flexibility to change technology within the same factory to become competitive. Flexibility in labour laws is expected outside the Budget by kindling reforms at the State Level. Rajasthan and MP have shown the way
- Where are the people to support manufacturing? Not enough skilled labour. What does the budget do for it? An attempt to create incentive to work by seeking to modify MG NREGA in June last year faced flak, this budget has softened things not by diluting the change but by increasing the outlay. Labour in the not-so-backward districts may come back to work to earn a living.
- Better logistics and Common market are required to be competitive. The implementation of GST would reduce cascading taxes, etc.

- Where is the Land? There are challenges which are being tackled outside the Budget. Let us hope than pragmatism overcomes politicking. I am not very hopeful on this one but let us not lose hope altogether.
- For reviving demand, the government is planning to take the lead in investing. The private sector is likely to wait to see whether Government actually acts on reviving the infrastructure sector, the mining sector, etc. and finds solution to many of the bottlenecks that have demotivated the private sector to invest in new ventures, etc., by demonstrating action on the ground. This Budget proposes a significant spend which, in turn, will revive the cement, automotive, metals (especially steel, aluminium, copper), which in turn helps to revive

Other clogs: Amongst the solutions to the other clogs are things like

- Direct Benefit Transfer of subsidies which not just reduces the cost of transfer to the beneficiaries by about 20% but also prevents leakages and delays in transfer.
- Proposed Bankruptcy law which will free locked up assets and time of various players in the system
- Making normal expenditure on livelihood expenses possible for the lower and middle class by eliminating crippling healthcare expenses during emergencies by creating a Social Security Scheme with the New Pension Scheme and boosting healthcare Insurance through various means
- Removing archaic laws and rules that dis-incentivised foreign investment and creation of an active debt market

Liver: Not digesting...

There is a consumer demand at the ground level but that is not getting converted into economic gain for the country because the manufacturing and agricultural sectors are not able to digest this demand in the absence of the required enzymes. This has resulted in countries like China, etc. reaping the benefits of our domestic demand.

Take for example the growing Pharma sector, which we are proud of. Do you realise that we are heavily dependent on import from China for many of the essential bulk drugs that go into the made in India drug formulations ranging from antibiotics to simple things like Paracetamol (Crocin for instance)? Not just a lost opportunity but also a big risk given that our relations with China are not exactly hunky dory.

Similar examples exist across the manufacturing spectrum, which require suitable targeted incentives. To a limited extent, the Budget does seem to address this aspect but regrettably, it is not enough. Hopefully, the Government will not wait for the next Budget to do more. Raising the share of manufacturing in India's GDP to 25% is not a trivial goal.

What has been done in the current budget for Make in India are......

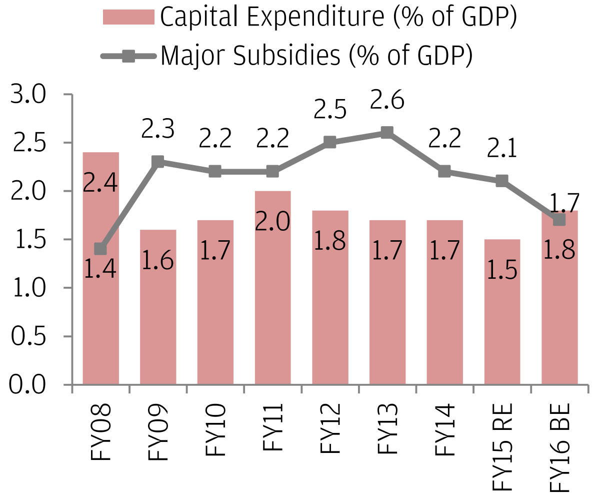
- Make formal skill training more effective by soon launching a National Skills Mission which will consolidate skill initiatives spread across over 20 ministries and departments
- The Rs 15 billion Deen Dayal Upadhyay Gramin Kaushal Yojana to train 1 million rural youth for jobs in 3 years
- Various initiatives to encourage new entrepreneurs and rebates in order to reduce the manufacturing costs
- An additional investment allowance of 15% and additional depreciation of 15% to new manufacturing units set up in notified areas of Andhra Pradesh and Telangana
- Additional depreciation of 20 % for new plant and machinery installed by a manufacturing unit or a unit engaged in generation and distribution of power
- Basic custom duty on certain inputs, raw materials, intermediates and components in 22 items is proposed to be reduced to minimize the impact of duty evasion
- Goods except populated printed circuit boards for use in manufacture of ITA bound items are proposed to be exempted from SAD
- GST from the next year to reduce cascading taxes
- Gross Corporate Tax to be reduced from 30% to 25% over 4 years but no deductions
- Income Tax on royalty and fees for technical services reduced from 25% to 10%

The kidney needs to be strengthened to remove toxins to improve the economy.

Some issues are:

- Black money, tax evasion and the parallel economy is a big toxin. Add to that poor enforcement and low sector coverage, and we get a situation where tax collection is about 10% of the GDP and a much smaller percentage of the unofficial GDP. India has the lowest tax to GDP ratios amongst Emerging Markets. Hopefully the Government will keep its promise to reduce this scourge through schemes announced in this Budget.
- Deficit financing to fund subsidies is a curse because it eats into the money available for capital expenditure. The good thing is that it likely that in the coming year, capital expenditure will exceed subsidies. The problem started when the Global Financial Crisis hit the world. See Chart

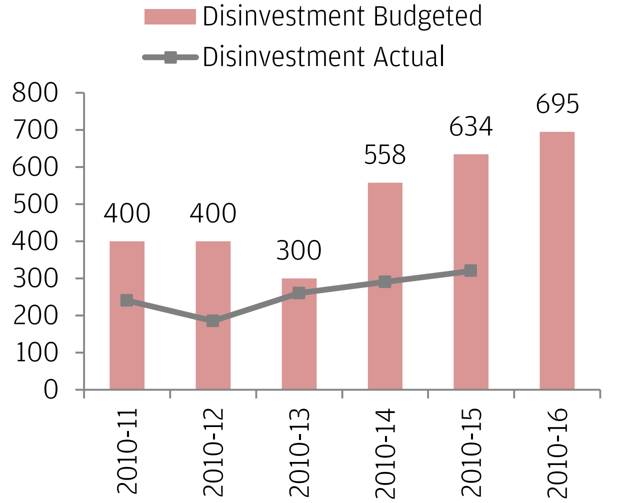
Capital Expenditure is finally exceeding subsidies



Source: Budget Documents

- 'Big Government' leading to huge unproductive expense. I am not confident on this score with the next Finance Commission's recommended wage hikes.
- A related toxic issue is debt financing to fund interest payment. In FY 2014-15 (and in recent years) interest payments were around a quarter of the total Budget outlay and most of the market borrowings were used for paying interest. Another way to look at it is that about 36% of the revenue collected in FY14-15 would go to paying interest. In the latest Budget, it is expected to go up to 40%. If that continues, kidney failure will result. No solutions are in sight. The hope is that adrenalin from growth will supress the symptom for the time being
- Fudgets instead of Budgets
  - The NDA Government had mastered the art of creating illusions: over estimating growth in revenues at the Budget time and under reporting expenses at the year-end.
  - Now we are seeing revised GDP estimates because the accounting base year and new parameters are being used, resulting in a new GDP series. All very well to update information to make it useful but new numbers for the past are rather confusing. We need clarification on what these new GDP numbers mean. I am used to thinking that 6 to 8% real GDP growth should make you and me, actually feel good but we did not feel good for the past 3 years. Did we? So what gives? Admittedly the nominal GDP growth for the next year looks realistic at 11.5% but only time will tell whether the assumed inflation rate is real or not.
  - I am a bit worried about the resource mobilisation through disinvestment in PSUs. The past record is not encouraging. See Chart:

Shortfall in Disinvestment Plans



Source: Budget Documents

Hopefully, the Modi Government will act quickly from Q1of FY15-16 and not wait until Q3 to start the process of disinvestments. The markets are hot now and there is probably not enough paper to invest in.

One final test- funds flow test:

In a turbulent global economy in which things which were up are now down, things which were down are now going up, will India get foreign funds flow at a time when most people believe that funds will continue to flow away from Emerging Markets to the Developed World especially when the US economy is looking up and the interest rate on dollars is likely to rise? We cannot grow unless we get the required funds flowing in.

My analysis suggests that India, due to its relative attractiveness vis a vis many other economies, will get at least as much as it did last year, thus increasing its share within the Emerging Markets slice of the cake. That is good news. If interest rates in India continue to stay high, we may get more than what is prudent.

CONCLUSION

On that happy note, let me conclude that we should be cautiously optimistic despite conflicting signals about the Budget that we will get from different quarters, some very optimistic and some distressing. This Budget seeks to rehabilitate the economy and address issues that will have good long term outcomes. It is not populist enough for some and too conservative for a few others. Time may prove both those quarters wrong. Thank you.

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